

contributions to economic
analysis

S. DELL / Editor

The International Monetary System and its Reform

Part I

North-Holland

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THE INTERNATIONAL MONETARY SYSTEM AND ITS REFORM

Part I

CONTRIBUTIONS TO ECONOMIC ANALYSIS

162

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United Nations project directed by Sidney Dell
1979-1986

Published in cooperation with the United Nations

PART I



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Introduction to the series

This series consists of a number of hitherto unpublished studies, which are introduced by the editors in the belief that they represent fresh contributions to economic science.

The term 'economic analysis' as used in the title of the series has been adopted because it covers both the activities of the theoretical economist and the research worker.

Although the analytical methods used by the various contributors are not the same, they are nevertheless conditioned by the common origin of their studies, namely theoretical problems encountered in practical research. Since for this reason, business cycle research and national accounting, research work on behalf of economic policy, and problems of planning are the main sources of the subjects dealt with, they necessarily determine the manner of approach adopted by the authors. Their methods tend to be 'practical' in the sense of not being too far remote from application to actual economic conditions. In addition they are quantitative.

It is the hope of the editors that the publication of these studies will help to stimulate the exchange of scientific information and to reinforce international cooperation in the field of economics.

The Editors

PREFACE

The studies of international monetary problems contained in the three volumes of which this is the first were originally prepared for submission to the Group of Twenty-four (G-24). That Group had been established in November 1971 to increase the negotiating strength of developing countries in discussions that were going on among IMF members at that time, on the future of the international monetary system. Developing countries felt that they should play a meaningful role in decisions about the system, and that the effectiveness of that role would be enhanced if they were to meet regularly as a group, as the developed countries had been doing for some time in the Group of Ten (G-10).

It soon became apparent that the G-24 were in need of technical support and analysis relating to the issues arising for discussion in the Fund and Bank, including the Interim and Development Committees. In response to representations by the Chairman of the G-24 to the Secretary-General of the United Conference on Trade and Development (UNCTAD), and following discussions between UNCTAD and the United Nations Development Programme (UNDP), the latter agreed in 1975 to establish a project to provide the technical support that the G-24 had requested. This was to take the form, principally, of analytical papers prepared by competent experts on issues currently under consideration in the fields of international money and finance.

Among the more important of the issues arising since the initiation of the project have been the following:

- (a) Expansion in the resources of the Bretton Woods institutions in line with the balance-of-payments and long-term capital requirements of member countries;
- (b) The importance of structural adjustment as a factor in balance-of-payments problems, and the need for the adaptation of conditionality to the requirements for structural adjustment;
- (c) The international debt problem;
- (d) Impact of the exchange rate system on developing countries;
- (e) The position of low income countries in the international monetary system;
- (f) Financial and monetary aspects of international co-operation among developing countries;

- (g) Adoption and subsequent revision of a Programme of Action on International Monetary Reform; adoption of a report on the "Functioning and Improvement of the International Monetary System";
- (h) Measures to strengthen the SDR;
- (i) The question of the establishment of a substitution account.

Although the papers were all originally prepared for the specific purpose set out above, some of them subsequently circulated more widely. Since considerable interest has been expressed in having the entire series accessible in the public domain, they are now being made available to the public at large in the present form.

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THE BALANCE OF PAYMENTS ADJUSTMENT PROCESS
IN DEVELOPING COUNTRIES*

Sidney Dell and Roger Lawrence

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Foreword

It has been a major preoccupation of the United Nations Conference on Trade and Development (UNCTAD), ever since its establishment in 1964, to explore the relationships between problems arising in the fields of international trade, international finance, and the international monetary system, and to seek solutions to these problems through negotiations among developed and developing countries. UNCTAD initiatives have, at various times, included the development of schemes for linking international currency creation to the provision of development finance, and for effecting improvements in the compensatory financing facility of the International Monetary Fund (IMF); some of the latter proposals were subsequently adopted and enacted by the IMF.

Because of the interdependence of problems in the three separate spheres of money, trade, and finance, it is natural that the severe disequilibrium in the international monetary system that developed during the 1970s should have been a matter of deep concern in UNCTAD. That disequilibrium, accompanied by international currency instability on a scale not seen since the Great Depression, has had a profoundly detrimental effect on trade and development, especially of developing countries, and endangers basic goals of the United Nations for improving living conditions in these countries. It is, therefore, one of UNCTAD's most important tasks to determine the factors responsible for the present malaise and the options available to the international community for resolving the problems involved.

Aware of UNCTAD's work on the relationship between changes in the international monetary system and the devel-

opment problems of the Third World, the Intergovernmental Group of Twenty-four on International Monetary Affairs - a representative group of developing countries - approached the Secretary-General of UNCTAD in January 1975 with a view to obtaining UNCTAD assistance, with the support of the UNDP, in the elucidation of issues that were the subject of current negotiations in the international monetary field. The Administrator of the UNDP and the Secretary-General of UNCTAD responded by establishing a project designed to provide the assistance that had been requested by the Group of Twenty-four.

The present volume deals with one of the outstanding issues of concern to the Group of Twenty-four - namely the manner in which the burden of adjustment to balance of payments disequilibrium in the 1970s was distributed between developed and developing countries. It shows that developing countries have been faced with a burden of adjustment out of all proportion to the degree of their responsibility for the international disequilibrium that has prevailed in recent years. The report makes a number of recommendations of great importance for remedying this situation. These include a proposal that in determining the appropriate volume of balance of payments support to a developing country, and the conditions required for the provision of that support, it is important to distinguish between those elements of a balance of payments deficit for which the country is itself responsible, and those elements that are due to factors beyond its control. Moreover, the remedies for disequilibrium should be selected in such a way as to reconcile the need for balance of payments adjustment in the short run with the basic requirements of development in the longer run, and should in no case subordinate the latter to the former. In many cases, especially where adjustment calls for changes in the structure of production or trade, balance of payments support may be needed over periods considerably longer than those that are standard under existing arrangements. It is, therefore, suggested that a new facility be created to bridge the gap between the short-term lending of the IMF and the long-term lending of the World Bank.

I should like to endorse these conclusions and recommendations of the report, and commend them to the attention of the international community.

The report was prepared, at the request of UNCTAD, by Sidney Dell and Roger Lawrence. They, in turn, drew upon a series of case studies of balance of payments adjustment prepared specially for the present project. A list of the case studies, and those who prepared them, is included; they are available on request to the Division for Money, Finance and Development, Palais des Nations, Geneva.

The report was submitted to the Group of Twenty-four in March 1979 and is now made available to the general public.

Gamani Corea
Secretary-General of UNCTAD
July 1979

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1 The International Setting

INTRODUCTION

The 1970s have witnessed shifts of unprecedented magnitude in the current account balances of major groups of countries. During 1970-73, industrial countries as a group ran annual current account surpluses that varied between \$14 billion and \$19 billion, as shown in table 1.1. During the same period, non-oil-exporting developing countries ran annual current account deficits of between \$9 billion and \$12 billion, and oil-exporting developing countries current account surpluses rising to over \$6 billion by 1973.

This pattern was sharply altered in 1974 and the following years: the current account surplus of oil-exporting developing countries rose from \$6 billion in 1973 to \$68 billion in 1974. The counterpart of this shift was the emergence of deficits for industrial countries and developed primary producers, and a steep increase in the current account deficit of developing countries. In 1975, the current account of industrial countries swung back sharply into surplus, accompanied by a decline in the surplus of oil producers and an enlargement of the deficit of developing countries, which reached \$38 billion, a level about four times that experienced in 1972.

In 1976-77, the overall current account surplus of the industrial countries declined sharply, although in 1977 severe imbalances emerged within the group as between the deficit position of the United States and the surpluses of the Federal Republic of Germany, Japan, and Switzerland - an imbalance that continued into 1978. There was also a considerable reduction in the current account deficits of the non-oil developing countries as a group, from the \$38 billion peak in

Table 1.1. Current Account Balances of IMF Member Countries
(billions of dollars)

Country Grouping ^{a/}	1970	1971	1972	1973	1974	1975	1976	1977
Industrial countries ^{b/}	13.6	17.1	14.4	18.8	-3.9	26.0	6.8	0.8
Major oil exporters ^{c/}	0.2	2.0	3.0	6.5	67.8	34.7	40.9	35.4
Other primary producing countries	-12.6	-14.6	-8.0	-10.2	-44.4	-52.4	-38.9	-35.2
More developed areas ^{d/}	-3.2	-2.4	1.7	1.1	-14.5	-14.8	-13.7	-13.3
Less developed areas ^{e/}	-9.4	-12.2	-9.7	-11.3	-29.9	-37.7	-25.2	-22.0

Sources: IMF, Annual Report, 1978. Data for 1970 to 1973 supplied by the IMF.

^{a/} The following groupings of IMF member countries follow usual IMF practice.

^{b/} Austria, Belgium, Canada, Denmark, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, the United States.

^{c/} Algeria, Indonesia, Iran, Iraq, Kuwait, Libyan Arab Jamahiriya, Nigeria, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Venezuela.

^{d/} Australia, Finland, Greece, Iceland, Ireland, Malta, New Zealand, Portugal, Romania, South Africa, Spain, Turkey, Yugoslavia.

^{e/} IMF member countries not specified above.

1975 to \$25 billion in 1976 and about \$22 billion in 1977. In 1976, the decline was due to a cyclical upswing in exports to industrial countries accompanied by an improvement in terms of trade, but by 1977 the relatively slow recovery of industrial countries from the 1974-75 recession was reflected in a slackening demand for imports from developing countries. In both years, the growth in import volume of developing countries was moderate, due in part to widespread efforts of adjustment leading to a decline in growth rates. The aggregate deficit of these countries may have risen once more in 1978 as import volume increased and the previously favorable movement in the terms of trade was reversed. Meanwhile the aggregate surplus of oil-exporting countries declined irregularly to a level of some \$35 billion in 1977, and was expected to show a further large drop in 1978.

The sharp swings in payments recorded in table 1.2 reflect two major phenomena: the changes in the price levels of internationally traded goods that began in 1973 and continued into 1974 for all categories of goods; and the recession in OECD countries that occurred in 1975 and 1976, followed in subsequent years by rates of growth that were significantly below historical averages for comparable stages in the business cycle.

It is clear that the recession in the OECD countries (1) had a major impact on the external accounts of all countries in the international economy and, in particular, on the external accounts of developing countries. In the absence of a workable model of cyclical adjustment of the current account, particularly involving primary commodity prices, it is difficult to quantify this impact, even roughly. The section that follows does, however, present some evidence on changes in the volume of trade, which is one important route through which changes in levels of domestic activity affect current accounts. It also presents the available evidence on price changes and their effects on the current accounts of various groups of countries. The subsequent section then raises some general considerations regarding the character of the deficits of developing countries, and the extent to which adjustment was required. A third section reviews the mechanisms through which external disturbances are transmitted to the domestic economy, and examines certain questions relating to the financing of the deficits of developing countries.

SHIFTS IN CURRENT ACCOUNTS: PRICE AND QUANTUM CHANGES

Table 1.2 shows that commodity prices (excluding petroleum) and unit values of commodities exported by developing

Table 1.2. Selected price indexes for internationally traded goods
(1974 = 100)

	1971	1972	1973	1974	1975	1976	1977
Wholesale prices of selected commodities ^{a/}	44.4	50.6	78.2	100	82.1	92.3	111.2
UNCTAD Commodity price index ^{b/} of which:	39.3	43.7	64.6	100	79.5	85.1	106.5
Food and beverages	33.9	41.3	56.6	100	80.6	86.8	120.7
Vegetable oil seeds and oils	36.7	31.6	57.0	100	58.2	56.6	70.9
Agricultural raw materials	45.3	49.7	84.1	100	82.1	98.0	104.5
Minerals, ores, and metals	49.5	49.5	71.8	100	84.1	82.7	87.1
Petroleum price index ^{c/}	16.9	19.6	27.7	100	109.9	118.0	127.1
Unit values of manufactured goods exported by developed countries ^{d/}	64.8	69.7	82.1	100	112.3	113.0	123.4
Unit values of commodities exported by developing countries ^{d/}							
Food (SITC 0 + 1)	49.1	53.4	67.6	100	95.6	100.0	...
Raw Materials (SITC 2 + 4)	50.5	54.7	72.9	100	94.3	108.3	...
Nonferrous Metals (SITC 68)	50.8	51.4	97.4	100	68.2	104.1	...

^{a/} Source: IMF, International Financial Statistics, Excludes petroleum.

^{b/} Source: UNCTAD, Monthly Commodity Price Bulletin.

^{c/} Source: IMF, International Financial Statistics.

^{d/} Source: United Nations, Monthly Bulletin of Statistics.

countries roughly doubled between 1972 and 1974, and that the index of petroleum prices more than trebled. Unit values of manufactured goods also accelerated quite sharply during this period, rising at an average annual rate of 20 percent between 1972 and 1974, as compared with a rate of 8 percent for the preceding two years.

If the prices of all groups of traded commodities moved upward in 1972-1974, the situation was quite different in the following two years. As may be seen from table 1.2, the indexes for petroleum prices and unit values of manufactured goods exported by developed countries continued to move upward in these years, while the indexes of commodity prices all fell in at least one of these years, and in 1976 uniformly stood below their levels in 1974. The indexes of unit values of commodities exported by developing countries, which are generally less volatile than the commodity price indexes, also declined in 1975, but recovered sufficiently in 1976 to restore the individual indexes to their 1974 levels. Data available for 1977 show that prices of most commodities rose sharply in that year, with prices in all groups except vegetable oil seeds and oils and minerals, ores, and metals exceeding the previous peak levels reached in 1974.

The volume of exports expanded quite rapidly in 1972 and 1973, with all groups of commodities participating in the upswing, as shown in table 1.3. In 1974, the overall expansion in the volume of exports of developing countries slowed considerably, and certain categories of exports, such as food and beverages and nonferrous metals, recorded declines. In 1975, the overall index of the volume of exports fell by 5 percent, with only food and beverages and textiles and clothing showing increases.

These movements in the volume of exports of developing countries reflected quite closely the movements in industrial production in OECD countries. Aggregate industrial production in nine major OECD countries, when measured as the deviation from its own long-term trend, peaked in the third quarter of 1973, and moved downward throughout the remainder of 1973 and 1974, reaching a trough in the first quarter of 1975.⁽²⁾ It rose steadily through the remainder of 1975 and 1976. The counterpart of the rapid recovery in production during 1975 and 1976 was a substantial increase in 1976 in the volume of exports of developing countries. As may be seen in table 1.3, the total quantum index for developing country exports rose by 15 percent between 1975 and 1976, with all major categories of exports participating in the expansion.

Changes in terms of trade have had a marked influence on the shifts in current account balances in recent years. As may be seen from table 1.4, the variability of the terms of trade increased for all groups of countries in 1965-1975, as

Table 1.3. Quantum Indexes of exports of developing countries
(1970 = 100)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
<u>Total exports</u>	102	114	127	130	122	140	138 ^{a/}
of which:							
Food + Beverages (SITC 0 + 1)	102	109	115	105	112	122	
Raw Materials (SITC 2 + 4)	102	112	120	118	105	106	
Fuels (SITC 3)	101	109	124	128	109	123	
Industrial Products (SITC 5-8)	107	128	149	167	169	205	
of which:							
Nonferrous metals (SITC 68)	95	97	117	106	84	100	
Textiles + Clothing (SITC 65 and 84)	124	149	180	170	174	250	

Source: United Nations, Monthly Bulletin of Statistics, June 1978 Special Table G.

^{a/} Preliminary.

compared with 1960-1970. In the case of the higher income oil-exporting developing countries and the largest OECD countries, the increase in the later period was particularly sharp relative to the fluctuations of previous years. It is worth noting, however, that even after the relatively large increase in variability that occurred in the early 1970s, the variability in terms of trade of OECD countries remained lower than that experienced by developing countries during the "normal" 1960s. It is also clear from table 1.4 that during the more recent period the variability in terms of trade of developing countries has been greater than that of OECD countries.

The implications for trade balances of these price swings are explored in table 1.5 for the period 1973 to 1976. The first eight columns of that table record for various groups of countries the magnitude of changes in import and export prices, each expressed as a percentage of the total value of trade of the particular group during the immediately preceding year. The next four columns record the total net effect of changes in import and export prices, expressed as a percentage of the value of imports and exports in the preceding year. The last eight columns break down the total price effect on trade balances into that part attributable to changes in the relative prices of imports and exports (the "terms of trade effect") and that attributable to the overall increase in the prices of traded goods (the "inflation effect"). Equiproportional increases in import and export prices lead to a deterioration in the trade balance when there is initially a trade deficit, and to an improvement in the balance when there is initially a trade surplus.

As may be seen from table 1.5, the trade accounts of all groups of countries were affected by rising import prices in 1973, the magnitude of the impact ranging from 6 to 7 percent of the value of trade for OECD countries to 12 to 13 percent in the case of non-oil-exporting developing countries. In 1974, the negative impact of increased import prices rose significantly, reaching 20 percent or more of the value of trade for all groups of countries other than the smaller OECD countries, for which the increase was 15 percent. This represented a disruption on the import side of unprecedented magnitude.

Export prices also rose for all groups of countries in 1973, and for middle-income developing countries the rise was quite abrupt, reflecting, in particular, the sharp advance in metals prices that year. In 1974, export prices continued their advance and, in the case of OECD countries and the poorest of the developing countries, the rate of increase was substantially higher than in the preceding year. In general, however, the export price changes were not of the same magnitude as the import price changes, so that the total price

Table 1.4. Coefficient of variation of terms of trade indexes: selected groups of countries, 1960-1975
(percentages, unweighted averages)

Period	OECD countries		Developing countries with per capita GNP ^{b/}			
	Total	Five ^{a/} countries	Other	\$301-\$800		
				over \$800	incl. oil - exporting countries	excl. oil - exporting countries
1960-1970	3.77	2.38	4.20	7.49	9.20	8.74
					incl. oil - exporting countries	excl. oil - exporting countries
1965-1975	7.03	6.82	7.09	26.04	11.46	14.01
					12.40	13.26
					8.98	8.50
						10.67
						8.48

Source: United Nations, based on information made available by the UNCTAD Secretariat; World Bank Atlas, 1976.

^{a/} France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States.

^{b/} GNP per capita figures are for 1974.

Table 1.5. Price changes affecting trade balances and their decomposition, 1973-1976

	Change in import prices ^{a/}				Change in export prices ^{b/}				Total price effect ^{c/}				The "inflation effect" ^{d/}				The "terms of trade effect" ^{e/}			
	1973	1974	1975	1976	1973	1974	1975	1976	1973	1974	1975	1976	1973	1974	1975	1976	1973	1974	1975	1976
Five OECD countries ^{f/}	-7.4	-21.5	-3.6	-2.8	4.8	12.1	4.1	2.1	-2.5	-10.8	0.9	-0.7	-0.5	-0.7	-0.5	-0.2	-2.0	-10.1	1.5	-0.5
Other OECD Countries	-6.0	-15.3	-4.4	-6.9	6.3	13.8	4.2	4.0	0.3	-7.8	-0.4	-2.9	-0.6	-3.1	-0.2	-1.0	0.8	-4.6	-0.1	-1.9
Non-oil developing countries with per capita GNP of:																				
more than \$800	-13.3	-24.8	-4.7	-2.2	10.4	13.6	0.4	2.0	-3.3	-10.6	-3.9	-0.2	-4.0	-6.4	-1.5	-0.8	0.7	-4.2	-2.4	0.6
\$301-\$800	-13.4	-20.8	-3.4	-2.4	22.0	22.6	-1.8	4.6	8.6	1.8	-5.2	2.2	-1.9	-1.8	-0.5	-0.7	10.5	3.6	-4.8	2.9
\$300 and below	-12.2	-23.0	-3.2	-2.2	10.6	18.5	-0.1	3.9	-1.8	-4.4	-3.2	1.7	-0.9	-1.8	-0.8	-0.9	-0.9	-2.6	-2.4	2.6

Source: United Nations, based on information made available by the UNCTAD Secretariat.

^{a/}The change in the import bill attributable to price changes, expressed as a percentage of the value of trade (imports plus exports) in the preceding year. A negative entry indicates an increase in import prices.

^{b/}The change in export earnings attributable to price changes, expressed as a percentage of the value of trade in the preceding year. A positive entry indicates an increase in export prices.

^{c/}The amount by which trade balances changed because of net changes in import and export prices, expressed as a percentage of the value of trade in the preceding year. A minus sign indicates a net movement of import and export prices that worsens the trade balance.

^{d/}The amount by which trade balances would have changed if export prices had changed by the same proportion as import prices (that is, had the terms of trade remained unchanged), expressed as a percentage of the value of trade in the preceding year.

^{e/}The total price effect less the "inflation effect."^a This equals the amount by which the trade balance would have changed as a result of movements in the relative prices of imports and exports, had the trade balance been initially zero. This amount is again expressed as a percentage of the value of trade in the preceding year.

^{f/}France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States.

effect on trade balances was negative. In 1974, the negative impact on trade balances was enormous in the case of the OECD countries and the more advanced non-oil developing countries, amounting to about 10 percent of the combined value of imports and exports in the preceding year. In the case of the lowest-income developing countries, the impact was somewhat less, amounting to about 4 percent of the value of trade, and for middle-income countries prices continued to exert a positive influence on trade balances, albeit at a greatly reduced rate.

In 1975 and 1976, price movements were greatly reduced as compared with the preceding two years; and, in the OECD countries, they had a negligible effect on trade balances. In the case of developing countries, the advance in export prices that had characterized the preceding two years came to a halt in 1975; and, in the case of middle-income countries, there was a decline equal to about 2 percent of the value of trade in the preceding year. Thus, even relatively modest advances in import prices produced overall price effects on trade balances of considerable magnitude. In 1976, however, export prices rose again, and the total price effect on trade balances was mildly positive, except for the higher income group.

Table 1.5 also shows that the "inflation effect" (that is, the effect of the general rise in foreign trade prices in widening trade deficits or increasing trade surpluses) had little impact on the trade balance of OECD countries as a group during the period examined, except for the smaller OECD countries in 1974. The "inflation effect" was an important phenomenon, however, for developing countries, and particularly for the higher income group. In 1973, the negative effect on the trade balance of these countries of rising prices overwhelmed the small positive change that occurred in the terms of trade, producing a negative total price effect on the trade balance. Similarly, despite a sizeable deterioration in terms of trade in 1974, the effect on the balances of these countries of rising prices was more important than the effect of the change in relative prices per se.

The increased relative importance over the past several years of price movements as a source of disturbance in the external accounts is examined in table 1.6, which records for two time periods the average size of observed year-to-year deteriorations in trade balances of non-oil developing countries and OECD countries, and the proportion of instances in which the primary factor(3) in the deterioration can be attributed to changes in import or export prices or volume. The table shows that, during the period 1962 to 1972, deteriorations in trade accounts were associated more frequently with an expansion of import volume than with any other single factor, a conclusion that holds for both developing and OECD countries. For developing countries, decreases in export

Table 1.6. Principal factors in year-to-year deterioration in trade accounts: 1962-1976

	Non-oil developing countries				Five OECD countries ^{a/}		Other OECD countries	
	1962-72	1973-76	1962-72	1973-76	1962-72	1973-76	1962-72	1973-76
1. Number of observations	414	148	26	12	104	47		
2. Average deterioration in trade accounts (millions of dollars)	48	293	1,233	5,708	227	1,052		
3. Percentage of observations in which the primary factor ^{b/} was:								
a. increase in import quantities	32	12	43	0	30	19		
b. increases in import prices	6	26	14	67	14	33		
c. decreases in export quantities	27	17	14	22	24	17		
d. decreases in export prices	13	25	7	0	9	19		
e. not assigned	22	20	21	11	22	12		

Source: United Nations, based on information made available by the UNCTAD Secretariat.

^{a/} France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States.

^{b/} For the definition of "primary factor" see p. 10 and p. 147, Note 3 to Chapter 1.

quantities and prices were also relatively frequent causes of deterioration in trade balances. These factors figure less often for OECD countries, however, and particularly for the five large OECD countries.

This pattern changes radically after 1973. The frequency of increases in import volumes as a primary factor in explaining deteriorations in trade balances diminished greatly relative to the earlier period. At the same time, the frequency with which import price changes appear as a primary factor increased dramatically for all groups of countries, and the frequency of export price declines increased for all groups other than the large OECD countries.

With regard to developing countries, the relatively high frequency with which increased import volumes appear as the primary factor during 1962 to 1972 is consistent with the view that deteriorations in the trade accounts of these countries, and accompanying deteriorations in their overall payments positions, were often associated with the demand pressures for imports resulting from the development process, as well as from short-run problems of demand management. As for the OECD countries, the high frequency with which deteriorations in trade balances during 1962 to 1972 were attributable primarily to increases in import volume is consistent with the view that excess demand was often translated into additional pressure for imports. Similarly, the sharp reduction in the frequency with which import volumes appear as a primary factor in 1973-1976 suggests that, during this period, demand pressures emanating from domestic economies were far less important relative to other sources of change in the trade balance than had previously been the case. Consequently, both at the national and international level, policies that assumed that excessive demand pressures were still the most important feature of payments problems were in need of review.

CURRENT IMBALANCES AND THE ADJUSTMENT PROCESS

The preceding discussion has suggested that significant changes have occurred in recent years regarding the underlying causes of payments imbalances. A question that arises is whether these changes imply a need for modifications in the adjustment process. An efficient adjustment process may be defined as one in which the economic costs of dealing with external imbalances are minimized. This will occur when two conditions are met. First, the adjustment process should require as small an idling of productive resources as possible, and when some loss of output is inevitable, the period during which the loss continues should be as brief as possible.

Secondly, frictional costs involved in reallocating resources within the domestic economy should also be minimized. This, in turn, requires that resources should not have to be reallocated domestically in response to transitory or reversible disturbances in the external accounts; and when domestic reallocation of resources is required, it should be allowed to take place over a reasonable time span. The reason for this is that the costs of reallocating resources almost invariably rise, and beyond some point rise steeply, as the time period within which reallocation must occur is reduced. A "reasonable" time span for adjustment is, thus, one in which the process is not pushed at a pace that generates costs, a substantial proportion of which could be avoided by slowing the rate of adjustment.

Consideration of the sources and character of present deficits in the light of these criteria suggests the following conclusions. First, an efficient adjustment mechanism would be one in which the cyclical component of the poor growth performance of OECD countries since 1975, and its effect on trade balances - particularly those of developing countries - was specifically acknowledged. An efficient adjustment process would be one in which deficits associated with the business cycle in OECD countries were financed in full. Secondly, the reallocation of resources and adaptation of economies required by the sharp changes in prices that have occurred in the recent past would need to be accomplished by policies requiring a number of years for their full effects to be felt. Additional resources may be required to expedite this process, including additional development finance. In addition, an efficient payments mechanism would provide adequate finance to cover this period of adaptation, and would provide the finance at maturities that correspond to that period. This suggests that the appropriate maturity of payments finance to cover the external deficits that have emerged during the past several years would be longer than in the past.

A further consideration is that the current account deficits that have emerged in recent years have, in part, structural surpluses as their counterpart. To a considerable degree, these surpluses are themselves a source of finance for meeting the need of deficit countries. However, the question arises as to how this finance is to be allocated among deficit countries. In addition to direct action by the surplus countries themselves, two possibilities exist in this regard: funds can be channeled through private financial institutions that will allocate them among borrowers according to their perception of relative creditworthiness; or they can be channeled through international institutions and allocated among deficit countries according to internationally agreed criteria. If, however, adequate finance at appropriate maturities is to be forthcoming to individual deficit countries, there is a strong presumption that greater use of international

institutions as a vehicle for intermediating funds between surplus and deficit countries will be required.

IMPORT CAPACITY, GROWTH, AND EXTERNAL FINANCE: AN OVERVIEW

The disturbances in the international economy that were sketched briefly in the first section were transmitted to the domestic economies of developing countries through a variety of avenues, many of which are quite complex. The sharp increases in export prices that occurred during 1973 and 1974 expanded purchasing power and imparted an expansionary impulse to private expenditure, and, where government revenues were reasonably elastic with respect to rising prices and incomes, to public expenditure as well. Subsequent declines in export prices, of course, had the opposite effect, and the sharp increase in import prices produced a deflationary impact on expenditure. The balance of these forces varied from country to country, and, for individual countries, from year to year. The rise in prices of traded goods could also be expected to have contributed to an acceleration in the rate of domestic price increases in developing countries, and changes in relative prices to have altered the relative rates of return on individual investment projects, and to have required re-examination of, and in some cases alteration in, development plans. Changes in relative prices can also be expected to affect different groups within a developing country in different ways and, therefore, to affect income distribution.

Of all the various ways in which external forces affect the economies of developing countries, their impact on the capacity to import is of particular significance. This, of course, reflects the importance of imports as a source of essential consumer goods (such as basic foodstuffs), of investment goods required to expand productive capacity, and of intermediate goods and raw materials necessary to ensure the full utilization of existing productive capabilities. Changes in import capacity, or its rate of growth, can, therefore, be expected to have considerable influence on developments in the domestic economy, even when account is taken of the possibility of compressing nonessential imports, and of other measures that could, for a short period of time, loosen the relationship between imports and growth.

This expectation is generally borne out by the information contained in table 1.7, which records average growth rates for GDP and its principal components for two groups of developing countries: those that experienced a real growth rate of imports from 1973 to 1976 equal to or greater than that

Table 1.7. Import Capacity and Economic Performance of Non-Oil Developing Countries
(unweighted averages of average annual percentage rates of growth)

	GDP		Domestic Investment		Government Consumption		Private Consumption		Agricultural Output		Manufacturing Output	
	1965-73	1973-76	1965-73	1973-76	1965-73	1973-76	1965-73	1973-76	1965-73	1973-76	1965-73	1973-76
30 countries with sustained or improved growth of import capacity ^{a/}	4.3	5.3	6.1	15.3	4.7	6.7	3.9	5.1	2.2	4.9	6.8	5.7
40 countries with diminished growth of import capacity ^{b/}	4.9	2.9	5.3	4.3	6.2	5.4	4.3	2.8	2.5	2.6	7.2	3.3

Source: United Nations.

^{a/} Countries having an average annual rate of growth of import volume in 1973-76 equal to or greater than that experienced during 1965-73.

^{b/} Countries having an average annual rate of growth of import volume in 1973-76 below that experienced during 1965-73.

experienced from 1965 to 1973, and those that did not. As may be seen from that table, the first group of countries recorded average rates of growth of GDP and its major components that were higher from 1973 to 1976 than in the earlier period, with the exception of manufacturing output, where a relatively mild decrease in the average growth rate occurred. The second group, on the other hand, experienced declines in average rates of growth of GDP and its components from 1973 to 1976 as compared with the earlier period, except for agricultural output, where growth rates remained unchanged. Moreover, the growth of manufacturing output fell quite sharply for this group of countries.

It is true, of course, that not all of the differences in the average performance of the two groups can necessarily be attributed to differences in import availabilities. The first group of countries, for example, experienced on the average improved agricultural output, and it must be presumed that climatic and other factors not related to import availabilities played an important role in producing this outcome. Improved agricultural performance, in turn, clearly contributed to the more rapid advances of private consumption and GDP. Even when account is taken of such considerations, however, the evidence presented in table 1.7 suggests that changes in the growth of import capacity were an important determinant of changes in economic performance, and that slower import growth and reduced economic performance affected a substantial number of non-oil developing countries after 1973.

This evidence also raises questions as to the role played by financial flows in sustaining the import capacity of non-oil developing countries throughout this period. Table 1.8, which records the main components of the aggregated current and capital accounts of these countries, shows that the flow of long-term capital and official transfers accelerated in both 1974 and 1975 but, nonetheless, failed to meet the financing needs emanating from the enlarged current account deficit. Consequently, the basic balance of these countries as a group swung from a surplus of \$7.5 billion in 1973 to a deficit of \$3.3 billion in 1974 and of \$5.3 billion in 1975, a swing that had to be absorbed by changes in short-term capital flows and in reserves and related items.

The salient feature of table 1.8, however, is the relatively modest recourse to official payments finance, that is, to IMF credit. Moreover, as the memo items under that entry make clear, the use of Fund credit that did occur was concentrated almost entirely on two of the Fund's facilities; use of regular tranche drawings during this period was minimal. Given the difficulties of many developing countries in maintaining import capacity, this raises a question as to whether official payments financing was sufficiently "available" during this period, and whether some countries were required by an

Table 1.8. The Balance of Payments of Non-Oil-Exporting Developing Countries: 1971-1977
(millions of dollars)

	1971	1972	1973	1974	1975	1976	1977
Trade Balance (merchandise FOB)	-8,584	-6,426	-6,520	-22,151	-28,703	-15,854	-12,921
Services	-4,898	-5,106	-7,317	-10,433	-12,465	-13,670	-13,860
of which investment income	-3,620	-4,358	-6,037	-6,742	-8,337	-10,620	-11,706
Private unrequited transfers	1,327	1,836	2,527	2,644	3,525	4,314	4,818
Current Account Balance	-12,155	-9,696	-11,310	-29,940	-37,643	-25,210	-21,963
Private long-term capital	4,702	7,208	8,324	11,566	13,804	14,156	12,876
of which direct investment	2,166	2,476	4,170	4,379	4,824	4,455	4,767
Government long-term capital	3,577	4,247	6,347	6,949	12,024	14,023	15,003
Government unrequited transfers	2,235	2,747	4,183	8,123	6,466	5,732	6,876
Total long-term capital plus Government transfers	10,514	14,202	18,854	26,638	32,294	33,911	34,755
(Memo item: total flow of concessional finance as reported by donor countries	6,336	6,906	8,926	13,025	17,433	16,434	18,826
of which, bilateral flows from other developing countries	-	-	1,043	3,038	4,921	4,405	5,576
of which, bilateral flows from DAC member countries and flows from multilateral financial institutions)	6,336	6,906	7,883	9,987	12,512	12,029	13,250
Basic Balance	-1,641	4,506	7,544	-3,302	-5,349	8,701	12,792
Short-term and other	2,919	1,268	48	4,733	4,458	-202	-427
Reserves and related items	-1,278	-5,774	-7,592	-1,431	891	-8,499	-12,365
Use of IMF Credit	58	329	166	1,363	1,598	2,045	-80
(Memo item: gross oil facility drawings)	-	-	-	919	1,547	577	-
(Memo item: gross compensatory drawings)	69	325	135	129	182	1,679	191

Sources: IMF, International Financial Statistics; OECD, Development Co-operation (Paris), various issues; UNCTAD, Handbook of International Trade and Development Statistics: 1977 Supplement.

effective scarcity of such finance to embark on adjustment processes that were unnecessarily costly to them and inefficient from the standpoint of the system as a whole.

The sharp increase in payments imbalances that occurred after 1973 was substantially reversed in 1976 and 1977. As may be seen from table 1.8, in 1977 the trade deficit of non-oil-exporting countries was less than half the deficit registered in 1975. This, together with a further expansion of long-term capital flows, resulted in the emergence of a sizeable surplus in the basic balance in 1977, allowing a substantial build-up of reserve assets. It could not be concluded, however, that by 1977 the effects of the disturbances of 1974 to 1975 had disappeared. Indeed, these events have left a legacy that will temper economic performance and policymaking for some time to come. The more important elements in this legacy are the lower growth rates in the world economy and especially in developing countries, and the increased vulnerability of developing countries to external shocks or other unforeseeable disruptions to the growth process. Slower growth in developed countries, together with intensified protectionist measures in a number of them, have prevented a strong advance in the volume of developing country exports, and are likely to inhibit such an advance in the immediate future. Consequently, for a number of developing countries, improvements in the trade balance have reflected a sharp reduction in the growth of imports in real terms, which frequently led to lower real growth in GDP. For others, the improvement reflected increases in the prices of their commodity exports - increases that may prove less permanent than those affecting the cost of their imports. Furthermore, those countries that had taken advantage of ready access to private capital markets to finance the enlargement in their current account deficits in 1974 and 1975 are unlikely to be able to secure additional financing of the same magnitude from this source in the immediate future, should this be necessary. A few of these countries, moreover, have incurred increases in debt service ratios to levels that may act as a constraint on import capacity and, hence, on growth in the near term. And despite recent increases in the current dollar value of reserve assets, the ratio of reserves to imports has fallen substantially for a large number of developing countries. For all these reasons, the problem of maintaining a reasonably sound external position in a context of adequate growth in GDP will continue to encounter difficulties.

The issues raised by the examination of the situation of developing countries in the preceding paragraphs can be explored in a satisfactory way only through detailed analysis of the experience of individual countries. In order to obtain such a detailed analysis, studies of the experience of thirteen developing countries (Brazil, India, Indonesia, the Ivory

Coast, Jamaica, Kenya, the Republic of Korea, Peru, the Philippines, Sri Lanka, the United Republic of Tanzania, Uruguay, and Zambia) were undertaken by expert consultants. The results of these country studies are summarized in the chapter that follows.

2

Impact and Response

INTRODUCTION

The thirteen countries of which special in-depth analyses were made for the purposes of the present study differ considerably in their underlying characteristics. Some (Indonesia, Peru, Zambia) are richly endowed with mineral resources, while others (Ivory Coast, Kenya, Tanzania) are basically agricultural economies. In some (Brazil, India, Republic of Korea) manufacturing and other industrial activities produce a substantial and rapidly growing proportion of national output, whereas in others (Tanzania, Zambia) industrialization is still at an early stage. Some (Jamaica, Zambia) are small economies that are 'open,' in the sense that international trade constitutes a relatively large proportion of total activity. In some of the economies (Kenya, Philippines) economic policies are basically market-oriented, while in others (Sri Lanka, Tanzania) official control or guidance is exercised over a substantial proportion of economic activity. Some countries (Brazil, Republic of Korea, Peru) borrowed heavily from private capital markets to finance balance of payments deficits, while others (Sri Lanka, Tanzania) relied wholly or mainly on official sources for their external financing.

The overall performance of the various economies during the early 1970s also differed substantially. During the period from 1970 to 1973 some countries (India, Jamaica, Sri Lanka, Uruguay, Zambia) grew at relatively low rates, or not at all.⁽¹⁾ Others (Brazil, Indonesia, Republic of Korea) grew at average annual rates that exceeded 8 percent during this period. After 1973, however, certain broad patterns emerged in the performance of these countries. From 1974 to 1976, all these countries experienced at least one year of sharp deteri-

oration in their current accounts and, for most, sharply higher current account deficits characterized the entire period. The widening of current account deficits was accompanied by an increase in long-term capital inflow. Except for India and Indonesia, the basic balance (the current balance plus long-term capital flows and official remittances), nevertheless, swung into deficit during one or more years after 1973, leading to recourse to payments finance and drawing on reserves. During the same period, overall economic performance deteriorated in most of the 13 countries: only Uruguay experienced rates of growth of GDP in each of the years 1974 through 1976 that were higher than those recorded in the 1971-73 period, while the majority of countries experienced a slowdown in growth for the period from 1974 to 1976 as compared with 1971-73. At the same time, rates of price inflation accelerated in all countries, though in the case of India the inflation had been brought under control by 1975.

The developments described in the preceding paragraph were, to a considerable degree, a reflection at the country level of the changes in the world economy described in chapter 1. Given the wide variety of country characteristics and past performance mentioned above, the manner in which these changes impinged on national economies and the response of policymakers could be expected to vary considerably. The remainder of this chapter is devoted to an analysis of the ways in which changes in the world economy affected the external accounts of the 13 countries, the effects of changes in the external accounts on developments in the domestic economy, and the policy measures adopted to counter the deterioration in external balance and in growth performance and prospects.

DEVELOPMENTS IN THE EXTERNAL ACCOUNTS

The sharp changes in key elements of the international economy referred to earlier had an immediate impact on the external payments of the 13 countries. In some of these countries, developments in the domestic economy also had an important influence on the external accounts in particular years. Nonetheless, movements in the prices of internationally traded goods remained the predominant source of change in the trade accounts of the 13 countries for the period as a whole. Indeed, as may be seen from table 2.1, in both 1974 and 1975 the negative impact on the trade balance of price movements amounted, on average, to more than 7 percent of the value of imports plus exports. In 1974, the negative price effects resulted, on average, from increases in import prices that outpaced advances in export prices. In 1975, the rise in import prices moderated, but export prices, on average, declined. The impact of negative price effects on trade bal-

Table 2.1. Price changes and trade balances:
12 developing countries^{a/}

	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Import price indexes ^{b/}	145	214	228	236	254
Export price indexes ^{b/}	139	188	175	186	226
Total net price effect ^{c/}	4.1	-7.3	-7.6	0.9	5.6
Change in trade balances ^{d/} (millions of dollars)	-453	-9,188	-2,284	6,748	4,342

Source: United Nations

^{a/} Brazil, India, Ivory Coast, Jamaica, Kenya, Republic of Korea, Peru, Philippines, Sri Lanka, Tanzania, Uruguay, Zambia. (Indonesia has been excluded because the behavior of its external accounts was fundamentally different from that of the others.)

^{b/} Unweighted averages: 1970 equals 100.

^{c/} The amount by which trade balances changed because of net changes in import and export prices, expressed as a percentage of the value of exports plus imports in the preceding year. A minus sign indicates a net movement of import and export prices that worsened the trade balance.

^{d/} Exports, f.o.b. less imports, c.i.f. Minus sign indicates deterioration in trade balance.

ances did not occur simultaneously in all countries, however. In India and the Republic of Korea, for example, the impact was felt primarily in 1974; for Tanzania and Zambia, negative price effects did not appear until 1975; and they did not make their appearance in Jamaica until 1976.

As may be seen further from table 2.1, the negative price effects were directly associated with deteriorations in the trade accounts. This is not to say that changes in the volume of trade played no role, however. During 1974, for example, there was a weakening of export performance in the Philippines, Sri Lanka, and Tanzania that resulted in declines in export volumes. In the Philippines, the reduction in volume was the result of falling external demand for wood exports, and a drop in copra and coconut oil exports due, in part, to government policies setting floor prices for exports of the two commodities that prevented Philippine exporters from competing successfully in international markets. (These policies were later rescinded after export earnings from the two commodities had fallen drastically.) In Sri Lanka, adverse weather conditions affected tea and rubber production, and in Tanzania drought affected agricultural exports, leading to a decline of 32 percent in the volume of coffee exports. In Brazil, an unusually sharp rise in import volume occurred in 1974 involving all major categories of imports other than food and fuel. This rise largely reflected inventory accumulation in anticipation of import restrictions. In 1975, import volumes declined, partly reflecting measures of import control that were introduced in the course of the year. These swings in volume greatly reinforced price effects in 1974 and offset them in 1975. Consequently, the Brazilian trade balance deteriorated sharply in 1974 but there was a sizeable improvement in 1975. There were also increases in the volume of imports in the Philippines, Tanzania, and Zambia in 1974. Despite these developments, however, price movements were clearly the principal cause of the deterioration in trade accounts.

As many be seen from table 2.2, the deterioration in trade balances in 1974 and 1975 determined the movements in the aggregate current account, with growing net payments for services enlarging the swing. In each of the countries concerned, the magnitude of the deterioration in the current account that occurred was without historical precedent. The expanded deficit in the current account was financed, in part, by an increased flow of long-term capital and government transfers, which rose from \$5.0 billion in 1973 to \$8.1 billion in 1974 and \$9.5 billion in both 1975 and 1976. The memo item in table 2.2 suggests that concessional finance (grants, and loans having a grant element of 25 percent or more) played little, if any, role in expanding long-term capital availabilities to these countries. Concessional financing played an important role in the case of India, however. (See table 2.6.) The

Table 2.2. Balance of Payments of Ten Non-Oil-Exporting Developing Countries:^{a/} 1970-77

	1970	1971	1972	1973	1974	1975	1976	1977
Trade Balance (merchandise FOB)	-15	-1500	-698	169	-7254	-8182	-4192	-770
Services of which investment income	-1533	-1772	-2075	-2918	-4128	-5322	-5886	-6867
	-885	-1000	-1258	-1642	-1781	-2963	-3522	...
Private unrequited transfers	64	38	88	115	136	164	148	21
Current Account Balance	-1484	-3234	-2685	-2634	-11246	-13340	-9930	-7616
Private long-term capital of which direct investment	757	1189	2518	3270	5211	5344	4671	...
	-21	411	564	1337	1225	1637	1570	...
Government long-term capital	598	949	1169	1437	2601	3817	4487	...
Government unrequited transfers	240	233	224	264	321	336	356	337
Total long-term capital and Government transfers	1595	2371	3911	4980	8133	9497	9514	10266
(Memo item: total flow of concessional finance as reported by DAC donor countries)	700	790	985	1057	1121	1326	1243	...
Basic Balance	111	-863	1226	2346	-3113	-3843	-416	2650
Short-term and other	1129	1126	1439	1120	2832	2382	3437	33
Reserves and related items ^{b/}	-1240	-263	-2665	-3466	281	1461	-3201	-2683
Use of IMF Credit	5	32	79	-10	241	389	667	76

Sources: IMF Balance of Payments Yearbook: Supplement to Vol. 28; OECD, Development Cooperation (Paris), various issues.

^{a/} Brazil, Ivory Coast, Jamaica, Kenya, Republic of Korea, Peru, Philippines, United Republic of Tanzania, Uruguay, Zambia, (Indonesia has been omitted because the behavior of its external accounts was fundamentally different from that of the others. India and Sri Lanka were not included because the requisite data were not available for the entire period covered.)

^{b/} Minus sign indicates increase in reserves and related items.

import equivalent of concessional flows declined sharply and abruptly after 1973. Moreover, the apparent proportion of concessional finance in total long-term financing fell from one-fifth in 1973 to one-seventh in 1974 and one-eighth in 1976. This, of course, largely reflects the increased current account deficits and long-term financing of Brazil, the Republic of Korea, and other countries that have relatively little access to concessional financing.

As may be seen further from table 2.2, the fact that long-term inflows rose less steeply than the current account deficit led to a swing of the basic balance from a surplus of \$2.3 billion in 1973 to a deficit of \$3.1 billion in 1974 and \$3.8 billion in 1975. To cover this deficit there was recourse to short-term borrowing and use of reserves and related items.

The pattern of movements described above for the ten developing countries as a whole also held for each individual country in the group of countries studied, except for the Ivory Coast and Jamaica, where both the current account and basic balance improved in 1974 and then deteriorated in 1975; and India, where the deterioration of the current account in 1974 was more than offset by increased long-term capital inflows.

PRESSURES TO ADJUST AND THE CAPACITY FOR ADJUSTMENT

The approach to these deficits and the policies adopted by governments varied considerably, depending in the first instance on the strength of their position in dealing with the onset of balance of payments pressures. That strength depended, in turn, on the reserves and borrowing capacity at their disposal as well as on the adaptability of their economies in carrying out the requisite shifts of resources. Thus Brazil, which was virtually able to decide for itself how much foreign borrowing it should undertake and had already gone far in the diversification of its economy, was able to reject any idea that the balance of payments problem might be solved through a recession designed to bring about a major drop in imports. According to Planning Minister Velloso: "One of the alternatives was ... to try to solve the problem of the trade balance through a recession which would lead to a strong reduction of imports.... Many people thought that this was the only way, even because it was the path that more experienced countries were following.... The government of President Geisel convinced itself that there was a better option." (2) Zambia, on the other hand, had few options. The exhaustion of reserves and borrowing capacity within a year of the onset of the crisis left no alternative but speedy adjustment that, in a small, open, and undiversified economy,

involved heavy costs to the country. The loss in real GDP from 1974 to 1977 amounted to 11 percent, or as much as 32 percent after allowance for terms of trade. Over the same period, per capita personal consumption dropped by close to 25 percent in real terms, while total real gross investment declined by more than 20 percent.

The severity and speed of the policy response depended not only on the level of reserves and on the availability and terms of external finance but also on the expectations of governments regarding the seriousness of the crisis and its probable duration, and their assessment of the feasibility of various alternative measures in the light of the economic and political situations in their countries. In Peru and Zambia, for example, the initial impact of the rise in import prices in 1974 was cushioned by a corresponding advance in the price of their main export - copper. It was not until the recession in the industrial countries brought about a decline in the price of copper in 1975 that the need for adjustment became apparent in these two countries. On the other hand, the coffee-exporting countries - Brazil, Ivory Coast, and Kenya - were able to revise their assessment of the seriousness of the crisis when coffee prices rose sharply in the latter part of 1975 and 1976 to unprecedented levels.

In addition to these general considerations, the character of the response by governments to developments in the external accounts was conditioned by the capacity of the economy to respond to measures designed to adjust the gap in external payments that could not be financed. Such adjustment could take the form of measures having the effect of increasing exportable supplies, or reducing import demand, or both. The more successful a country is in increasing exports, the smaller the burden imposed in reducing imports. However, the fact that a country takes steps to increase exportable supplies does not mean that additional exports will, in fact, materialize. Much depends on the state of world market demand.

The capacity for adjustment is by no means uniform among countries. There are marked differences in the ability to raise export earnings, particularly by expanding exports of manufactures or of other nontraditional products such as processed foodstuffs. Similarly, countries differ considerably in the extent to which they can compress imports without suffering adverse effects. From this standpoint, the countries included in the present study having the greatest capacity for adjustment are probably Brazil, India, and the Republic of Korea. All three have the potential for expanding nontraditional exports, particularly of manufactures, as well as for additional import substitution. The Philippines and Uruguay have a similar potential; and while Indonesia is not in the same category, its oil resources provide considerable

elasticity on the export side. At the opposite end of the spectrum, rigidities in the economic structure of Jamaica, Sri Lanka, Tanzania, and Zambia create significant obstacles to adjustment. Such rigidities include a high degree of concentration of exports on a very few primary commodities, and a relatively low capacity for compressing imports because imports have already been limited to essentials due to persistent pressure on the balance of payments. A middle group might consist of Ivory Coast, Kenya, and Peru. These countries, while sharing several characteristics of the least adaptable group, have a significant capacity for developing and diversifying their exports. Peru, however, has encountered special difficulties in the export sector due to the sporadic interruptions of fishmeal supplies and the stagnation of markets for nonferrous metals.

While there could be differences of opinion as to the way in which particular countries should be classified from the point of view of the elasticity of the foreign trade sector, the important point to note is that, since the capacity for adjustment varies from country to country by virtue of differences in economic structure, there is a presumption that adjustment policies should be adapted accordingly. For example, a cost-benefit analysis of a major currency devaluation may well yield quite different results from country to country, depending upon the probable responsiveness of actual or potential exports to such a step in the short- and medium-term. Likewise, a cost-benefit analysis of general measures to improve the trade balance by cutting domestic consumption would yield one set of results in a country in which exports were not consumed domestically and imported consumer goods consisted mainly of basic foodstuffs, and a different set of results when a substantial proportion of exportables is consumed domestically and there is a wide range of imported consumer goods.

In some cases, intercountry differences in approach reflected more than access to borrowing facilities and the elasticity of the economy. On both scores, Uruguay was fairly strongly placed. But the government that came to power in June 1974 attached high priority to a basic policy of opening up the economy to world market forces and reducing the scope of government involvement in business activity. This meant reliance on global fiscal and monetary policies and on exchange rate adjustment for correction of imbalances, in preference to the imposition or tightening of direct controls. A similar point of view was adopted by the government of Sri Lanka that took office in 1977. Here, too, it was felt that after a long period of strong governmental control over the economy, a move should be made towards a more market-oriented economy. The government recognized that the new policies of liberalization were not being undertaken from a position of strength, and

acted "in full awareness that the costs of adjustment will be painful because we believe this to be a more rational method of ordering our priorities and allocating resources within the country." (3)

MAINTAINING IMPORT CAPACITY: PERFORMANCE AND POLICIES

Although the pressures on countries to adjust, and the capacity to do so, varied considerably among the countries studied, a common concern was to maintain the flow of imports necessary to support the growth of output and income in the domestic economy. Accordingly, the following paragraphs examine the extent to which countries were able to adjust to the external imbalances confronting them without having to reduce their command over foreign goods and services - that is, their total import capacity. Total import capacity may be broken down into the following principal components: earned import capacity, which measures the volume of imports that can be purchased from the export proceeds of a country; and 'unearned' import capacity, which measures the volume of imports that can be purchased with the capital inflows that a country has succeeded in attracting. A third consideration that has a bearing, particularly during periods of payments stress, is the effect on import capacity of reserve management and access to official payments finance. Account also has to be taken of the need to service indebtedness and allow remittance of profits resulting from past capital flows. Such obligations are usually considered to have a first claim on earned foreign exchange and, consequently, operate to reduce a country's earned import capacity.

Table 2.3 sets forth indexes of import capacity and its components for 12 countries. This table permits an examination to be made of the evolution of earned import capacity over time, and of the extent to which any decreases in earned import capacity were offset by capital inflows and reserve use. As may be seen from this table, the earned import capacity of each of the 12 countries moved adversely in at least one year during the period from 1974 to 1976, and for a number of countries earned import capacity stood throughout the period at levels below those reached on average during 1971 to 1973. The loss of upward momentum in earned import capacity reflected the incidence of the rise in import prices and declines in export prices and/or volumes in some countries.

Of the countries identified earlier as having a relatively high capacity for adjustment, three (Brazil, Republic of Korea, and Philippines) had experienced a fairly substantial increase

Table 2.3. Indexes of Import Capacity and its Components: 1971-77
(1970 = 100)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977^a</u>
<u>Brazil</u>							
Earned import capacity ^{b/}	97	121	152	126	119	129	151
Unearned import capacity ^{c/}	180	385	368	412	362	364	389
Earned plus unearned import capacity	111	166	189	175	160	169	191
Total import capacity ^{d/}	117	124	170	227	211	171	223
(Memo: debt service ratio ^{e/})	14%	14%	11%	11%	15%	17%	18%
(Memo: reserves to imports ratio ^{f/})	47%	87%	92%	37%	30%	48%	55%
<u>India</u>							
Earned import capacity	98	111	108	96	122	...	...
Unearned import capacity	109	53	53	74	66	...	...
Earned plus unearned import capacity	101	96	93	90	107	...	...
Total import capacity	110	110	110	103	115	...	...
(Memo: debt service ratio)	24%	22%	20%	17%	13%	11%	10%
(Memo: reserves to imports ratio)	50%	53%	36%	26%	22%	54%	81%
<u>Ivory Coast</u>							
Earned import capacity	84	94	105	113	108	133	152
Unearned import capacity	121	71	188	108	145	126	248
Earned plus unearned import capacity	90	91	117	112	111	132	166
Total import capacity	96	104	123	113	123	140	151
(Memo: debt service ratio)	8%	8%	7%	8%	9%	9%	12%
(Memo: reserves to imports ratio)	22%	19%	12%	7%	9%	6%	12%
<u>Jamaica</u>							
Earned import capacity	107	110	90	119	116	92	95
Unearned import capacity	112	67	89	61	59	25	0
Earned plus unearned import capacity	108	98	90	103	100	73	64
Total import capacity	108	106	97	100	109	95	67
(Memo: debt service ratio)	4%	5%	5%	6%	7%	11%	15%
(Memo: reserves to imports ratio)	32%	26%	19%	20%	11%	3%	6%

(continued)

Table 2.3. (continued)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977^{a/}</u>
<u>Kenya</u>							
Earned import capacity ^{b/}	100	100	92	80	77	86	113
Unearned import capacity ^{c/}	91	92	101	88	64	67	9
Earned plus unearned import capacity	98	99	94	82	75	83	92
Total import capacity ^{d/}	120	104	100	98	86	85	82
(Memo: debt service ratio ^{e/})	8%	6%	5%	5%	4%	6%	5%
(Memo: reserves to imports ratio ^{f/})	30%	38%	38%	19%	18%	28%	41%
<u>Korea, Republic of</u>							
Earned import capacity	107	137	207	185	191	302	388
Unearned import capacity	101	87	87	92	126	132	101
Earned plus unearned import capacity	105	122	171	158	172	252	304
Total import capacity	111	118	163	168	168	228	282
(Memo: debt service ratio)	19%	17%	14%	10%	10%	9%	9%
(Memo: reserves to imports ratio)	24%	29%	26%	15%	21%	34%	40%
<u>Peru</u>							
Earned import capacity	81	81	75	77	63	61	67
Unearned import capacity	105	305	792	964	1603	836	1074
Earned plus unearned import capacity	82	89	100	108	116	88	102
Total import capacity	115	119	128	122	186	140	138
(Memo: debt service ratio)	16%	16%	30%	23%	25%	26%	30%
(Memo: reserves to imports ratio)	57%	61%	56%	63%	18%	17%	22%
<u>Philippines</u>							
Earned import capacity	100	96	132	126	102	103	118
Unearned import capacity	45	102	104	81	179	386	273
Earned plus unearned import capacity	94	97	129	122	110	131	133
Total import capacity	91	89	100	108	117	141	143
(Memo: debt service ratio)	7%	10%	9%	5%	7%	7%	6%
(Memo: reserves to imports ratio)	29%	39%	58%	43%	36%	42%	36%

(continued)

Table 2.3. (continued)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977^{a/}</u>
<u>Sri Lanka</u>							
Earned import capacity ^{b/}	95	85	78	69	72	71	88
Unearned import capacity ^{c/}	182	127	98	116	159	132	105
Earned plus unearned import capacity	105	89	80	75	82	77	90
Total import capacity ^{d/}	107	86	79	80	88	74	73
(Memo: debt service ratio ^{e/})	11%	14%	13%	12%	22%	20%	15%
(Memo: reserves to imports ratio ^{f/})	14%	16%	20%	11%	8%	16%	42%
<u>Tanzania</u>							
Earned import capacity	101	111	99	76	72	86	90
Unearned import capacity	177	140	168	126	159	78	118
Earned plus unearned import capacity	115	117	112	86	88	85	95
Total import capacity	113	100	103	99	87	79	75
(Memo: debt service ratio)	8%	13%	9%	7%	7%	7%	7%
(Memo: reserves to imports ratio)	16%	30%	29%	7%	8%	18%	39%
<u>Uruguay</u>							
Earned import capacity	80	110	93	37	39	77	75
Unearned import capacity	216	168	0	95	331	174	100
Earned plus unearned import capacity	89	114	86	41	57	83	77
Total import capacity	85	110	72	46	62	68	52
(Memo: debt service ratio)	23%	31%	23%	33%	46%	29%	28%
(Memo: reserves to imports ratio)	79%	96%	84%	48%	39%	54%	63%

(continued)

Table 2.3. (continued)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977^{a/}</u>
<u>Zambia</u>							
Earned import capacity ^{b/}	65	66	83	82	45	55	44
Unearned import capacity ^{c/}	...	...	11	37	82	28	18
Earned plus unearned import capacity	73	88	97	99	61	67	53
Total import capacity ^{d/}	126	127	121	119	80	87	68
(Memo: debt service ratio ^{e/})	10%	13%	30%	7%	10%	10%	19%
(Memo: reserves to imports ratio ^{f/})	44%	25%	29%	18%	13%	12%	9%

Sources: United Nations, based on information made available by the UNCTAD Secretariat; International Financial Statistics (Sept. 1978); IMF, Balance of Payments Yearbook, Supplement to Volume 28 (December, 1977); World Bank, Annual Report, 1978.

^{a/} Some components of these indexes have been estimated.

^{b/} Earnings from export of goods and services less gross payments on account of investment income, deflated by import prices.

^{c/} Net receipts of transfers and long-term capital, deflated by import prices.

^{d/} Earned and unearned import capacity plus changes in reserves and related items, deflated by import prices.

^{e/} Service payments on external public debt as a percentage of exports of goods and services.

^{f/} Total gross official reserves at the end of the year as a percentage of merchandise imports during the year.

in earned import capacity from 1971 to 1973, reflecting a marked ability to transform domestic resources into foreign exchange earnings on a growing scale. In two other countries in this group (India and Uruguay) the underlying capacity to expand foreign exchange earnings was somewhat weaker during this period, and earned import capacity did not register significant advances. The remaining countries showed no decided upward trend in their earned import capacity from 1971 to 1973, with the exception of the Ivory Coast, where import capacity recovered from the sharp decline experienced in 1971. Indeed, in some countries in this group (Jamaica, Peru, Sri Lanka), earned import capacity showed a decided downward trend during this period.

All countries sought to counter the declines in import capacity that occurred after 1973 by stimulating and diversifying exports, variously employing incentive and subsidy schemes, searching for new markets, and devaluing their exchange rates where necessary. However, the emphasis on export promotion varied considerably between countries, ranging from the Republic of Korea where it was the most important single element in the overall strategy of adjustment, to Zambia where the achievement of substantial short-term gains was virtually out of the question, given the country's undiversified productive base. Several countries that had not previously had much success in diversifying exports recorded important gains during this period. These included India, Philippines, Sri Lanka, and Uruguay. In India, a whole series of measures for the promotion of exports were adopted or strengthened, especially after 1972/73. These changes took effect after 1974/75 and the growth rate of export volume, that had begun to increase up to that year, accelerated sharply in the two years that followed. The increase of 10.5 percent in Indian export volume in 1975 was particularly noteworthy in view of the five percent decline in the volume of world exports of manufactures in that year. Indian measures included cash subsidies, duty drawbacks, various tax advantages and the linking of import licenses to exports. In the Philippines, an Export Incentives Act had been passed in 1970 offering strong tax and other inducements to exporters under the aegis of the Board of Investments. Additional incentives and assistance in marketing were provided in 1973 and subsequently. As a result, the dollar value of exports of nontraditional manufactures more than trebled from 1972 to 1975. In Sri Lanka, a combination of devices was employed to promote exports of gems as well as of industrial and other minor exports, perhaps the most significant being a scheme permitting exporters to retain a certain percentage of their earnings in convertible rupee accounts. This, together with the effect of premium exchange rates for minor exports and gradual currency depreciation in raising export profitability,

contributed to enlarging the share of nontraditional products in total exports from 16 percent from 1971 to 1973 to 27 percent from 1974 to 1976, while the increase in value was 260 percent. On the other hand, exports of tea, rubber, and coconut were adversely affected by weather conditions and, therefore, did not realize the full advantage afforded by high export prices during the period. Promotion of nontraditional exports was particularly effective in Uruguay, where the share in total exports rose from 22 percent of the total in 1973 to 52 percent in 1977. Exchange rate policy was designed to stimulate exports and included the provision of premium rates for exporters averaging over 23 percent in 1974. Other measures included special lines of credit; tax exemptions; and the establishment, with the support of the World Bank and USAID, of a Fund for development financing directed toward export promotion.

In Brazil, active policies of export promotion had been initiated in 1965, including the full rebate of indirect taxes paid at all stages of the productive process as well as other tax incentives, and these were followed in 1968 by introduction of the crawling peg, and in 1969 by the subsidization of manufactured exports. Consequently, major increases in the value and volume of exports of nontraditional manufactures and semi-manufactures had already occurred prior to the crisis. These increases continued during and after the crisis and were reinforced by a program specially designed to promote exports of manufactures by transnational corporations operating in Brazil. The program was administered by an independent commission known as BEFIEX, established under a decree of May 1972. Under this program companies prepared to accept a long-term commitment to expand exports in relation to imports were exempted from certain taxes and import duties, and from compulsory deposits on imported inputs. A 'balance of payments' was established for each company, and it is estimated that the net positive balance of transactions linked to the BEFIEX program increased from an average of \$229 million per annum in 1972-74 to \$547 million in 1977. (This estimate does not, of course, take into account the increase in exports that would have occurred in any case under previous concessions to exporters. However, the earlier concessions did not bring any pressure on exporters to increase the net balance of exports less imports.) In the Ivory Coast, policies for the diversification of agricultural exports as well as of markets were instrumental in facilitating the rapid growth of export earnings during this crisis period. Shortfalls in the supply of one crop due to drought or other difficulties were usually offset by expansion in other crops. In addition, exports of petroleum products to neighboring countries rose sharply beginning in 1974, contributing four to five percent to total export earnings.

EXCHANGE RATE POLICIES

The role assigned to exchange rate policies varied considerably among the countries studied. Broadly speaking, exchange rate policies were assigned a relatively important role in the management of the external accounts when there was a reasonably wide range of exportables, particularly manufactures, for which supply and demand were both relatively responsive to price changes; and where substitutes for imports existed, and increases in import prices would not be likely to have socially disruptive effects, either by initiating or accelerating a process of cost inflation, or by seriously altering the distribution of income. Where, on the other hand, there was thought to be little short- or medium-term elasticity in export demand or supply, and where imports consisted primarily of essential items not available from domestic production, exchange rate policy was generally assigned a lesser role in bringing about external balance. This was particularly the case where the application of direct import controls was already so tight that further economies in expenditure on imports were not likely to result from increases in import prices in terms of domestic currency; and where it was felt that increases in the import prices of basic consumption goods might have major adverse social repercussions. Even where this was the case, however, there was usually recognition of the need for maintaining an exchange rate that was realistic in the sense of providing a reasonable margin of profit on staple exports. But exchange rate changes were regarded by governments in this group as a last resort rather than as a ready instrument for balance of payments adjustment.

While most of the countries considered in this study found themselves, generally speaking, in one or other of the prototype situations described above, some found themselves in intermediate positions. In Brazil, the Republic of Korea, and Uruguay, exchange rate policy played an active role in support of policies designed to expand exports. In the Republic of Korea, exchange rate policy had been oriented for some time towards providing a strong incentive for exports, and no change in this underlying policy was deemed necessary after 1973. The official exchange rate was adjusted in line with changes in relative prices, so that the relative profitability of exporting remained roughly unchanged throughout the period. In Brazil and Uruguay, crawling peg exchange regimes were in force. For these countries, the issue did not lie between devaluing or not devaluing, because inflation rates were so high that exchange rate adjustments were inescapable. From 1973 to 1977 in Uruguay the average annual depreciation against the dollar was one-third, and in

Brazil just under one-fifth; in trade-weighted terms these rates of depreciation were presumably even higher. The main issue was whether devaluation should proceed through a large number of small steps or through less frequent but larger steps.⁽⁴⁾ The reason for the adoption of the former approach was to avoid the speculative capital flows characteristic of the latter method, whereby payments in foreign currency are concentrated in the months immediately preceding a devaluation, while receipts are bunched together in the period immediately following it. Exporters feel they benefit from a lessening of risk associated with a decrease in the variance of export prices in terms of foreign currency under a crawling peg system, while importers see advantages in more stable import control procedures. The monetary authorities gain by avoiding speculative losses and through the reduction in the amplitude of fluctuations in foreign exchange reserves.

At the other end of the scale, a remarkable degree of exchange-rate stability was maintained in India. The trade-weighted average rate of devaluation of the rupee against four major currencies (dollar, sterling, yen, and mark) amounted to only 2.0 percent from 1972/73 to 1974/75 and 4.3 percent from 1974/75 to 1976/77. However, the competitiveness and profitability of Indian exports probably increased substantially in 1975 and 1976, not only on account of the special incentives noted earlier, but because Indian export unit values for manufactures remained virtually unchanged in terms of dollars from 1974/75 to 1976/77 while world export unit values increased by about 12 percent. Likewise, considerable stability was maintained in the external value of the currency of the Ivory Coast (the CFA franc) which is pegged to the French franc at a fixed rate. In 1974 the CFA franc depreciated against the SDR by about 8.2 percent. This was followed in 1975 by an appreciation of 10 percent and by more moderate depreciations thereafter. These exchange rate movements did not have any significant effects on either exports or imports.

Exchange rate changes were also approached cautiously in Tanzania. The prices of Tanzania's exports are determined in foreign currency, so that devaluation would not raise export earnings unless the quantities supplied increased sharply. Moreover, any attempt by Tanzania to achieve a major increase in its share of export markets for primary commodities would provoke retaliation, in the course of which all exporting countries would tend to lose because of the consequential forcing down of prices. Devaluation was employed (in 1971 and 1975) when, in its absence, absolute cuts in domestic export prices or major export subsidies would have been needed. At the same time, since Tanzania operated both import controls and selective indirect taxation as instruments in its overall planning, devaluation was not necessary either to

limit imports or to reduce demand, and was regarded as far too unselective for frequent use as a supply/demand management tool. Thus, the external terms of trade would not be affected by devaluation, while any desired effects of devaluation on producer prices could be achieved by the use of other policy instruments. Moreover, the management of the price and income distribution effects of a major devaluation posed serious difficulties. It would tend to shift income from the relatively poor producers of food to the relatively richer exporters of cash crops, which was inconsistent with Tanzania's social objectives and the goal of raising food production.

In Zambia, the kwacha was devalued by 20 percent in July 1976, partly in order to offset the appreciation of the effective exchange rate, which was pegged to the dollar (the multilateral trade-weighted average rate of exchange of the US dollar increased from June 1975 to June 1976 by over 14 percent), but mainly because of the deterioration in the financial position of the mining companies. The devaluation implied that the rise in externally generated production costs (equivalent to 60 to 70 percent of total costs) would be offset through domestic adjustment. It probably contributed little or nothing to foreign exchange earnings, but helped to increase profitability at existing levels of production. But even these gains quickly disappeared as world copper prices fell further in 1977 and, by March 1978, another devaluation of 10 percent was considered necessary. The Zambian experience illustrates the manner in which a country is led to maintain or even increase production precisely because prices are low, instead of reducing production as a means of sustaining prices - a step that can, of course, be effective only if other producers do the same thing. The difficulty with the devaluation strategy, however, is that to the extent that it succeeds, it tends to increase excess supplies and, hence, depress prices still further, thereby making it necessary to undertake recurrent devaluation.

In Jamaica, the large sectoral differences in productivity and unit costs typical of developing countries prompted recourse in 1977 and the first half of 1978 to a brief period of multiple rates. The government considered that if the exchange rate were set at a level sufficiently high to provide an effective stimulus to nontraditional exports, uniform application of that rate would yield excessive profits to the bauxite industry. It would also mean hardship for the poorest members of the population because of the large increases in the prices of imported essentials that would result. Accordingly, while the currency was devalued by 37.5 percent for most transactions, the existing rate was retained for government and bauxite industry transactions and for a small list of basic foods and medicines. In effect, the dual rate was used

as a means of subsidizing nontraditional exports and highly essential imports - a reasonable strategy for an economy that is short of foreign exchange and has a much higher level of productivity in its traditional export sector than in the rest of the economy. However, in view of the incompatibility of multiple currency practices with the Articles of Agreement of the IMF, an alternative and equally efficacious method of securing the same result would be through a combination of differential taxes and subsidies on exports and imports while maintaining a uniform rate of exchange.

The application of exchange rate policies by several countries as described above, together with the direct measures to stimulate exports reported earlier, constituted a substantial effort to increase export earnings. These efforts were, however, partially frustrated by restrictive policies of developed countries that were simultaneously working to limit increases in certain categories of exports by developing countries. Such policies made it correspondingly more difficult for the exporting countries to adjust their external deficits without reducing their levels of trade and output. Although the major trading countries have, on the whole, resisted rising pressures for general recourse to protectionist measures, a growing number of specific protectionist measures made their appearance in 1972-73 and thereafter. Moreover, the measures adopted were frequently in sectors such as textiles, clothing and footwear, where developing countries have a decided comparative advantage. Increasing difficulties in expanding the volume of exports were, thus, encountered in a number of developing countries.

Among the countries covered by the in-depth study, Uruguay experienced particularly severe effects of protectionist measures, taking the form of restrictions on beef and veal imports by the European Economic Community (EEC) beginning in 1974. As a consequence of these measures, the volume of Uruguay's exports to the EEC of chilled and frozen beef had fallen by 1977 to about one-fifth of the levels reached in 1972-73. Owing to the importance of this trade, the decline had a considerable effect in curtailing the overall growth of Uruguay's exports. The Republic of Korea also experienced difficulties as a result of restrictive trade measures affecting exports, applied by developed countries. Restrictions on exports from the Republic of Korea which increased significantly after 1974 were imposed by Australia, Austria, Canada, the EEC, Finland, Japan, New Zealand, Norway, Sweden, and the United States. The principal export products affected by these restrictions were textiles, clothing, footwear, intermediate and consumer steel products, and electrical appliances. The proportion of total exports by the Republic of Korea subject to restrictions increased from about 15 percent in 1973 to around 22 percent in 1976. It has been estimated

that the loss in export earnings resulting from the restrictions may have amounted to as much as \$1 billion in 1977.(5) Exports from the Philippines were also subject to increased restrictions by developed countries after 1974. Again, restrictions on exports of textiles and clothing were particularly severe, but restrictions on other products, including wood and wood products, fish, shellfish, and pineapple preparations, were also imposed by a number of countries.

Despite the incidence of protectionist measures, the policies adopted by the countries to expand exports, together with the recovery of raw material prices that occurred after 1975 (see table 1.2), allowed a number of the countries to reestablish an upward trend in their earned import capacity following the unfavorable developments in 1974-75. Of the countries previously identified as having a relatively high capacity to adjust, India and the Republic of Korea experienced growth in earned import capacity after 1974 that quickly brought this index to levels higher than those experienced from 1971 to 1973, and in Brazil recovery to pre-1974 levels was achieved in 1977 (see table 2.3). In the Philippines and Uruguay there was also some advance in earned import capacity after 1974-75 and, in the case of Uruguay, the advance was quite marked. In neither country, however, had the best pre-1974 level been re-established by 1977.

Of the countries identified as being in an intermediate position in their capacity to adjust, Ivory Coast made a rapid advance in earned import capacity after 1975, and Kenya showed a sharp rise in 1977. Of the remaining countries in the sample, including all of those previously identified as having the least capacity to adjust, none had succeeded by 1977 in restoring earned import capacity to the best levels that had been reached between 1970 and 1973, although Sri Lanka and Tanzania had made progress in that direction. Thus, in five of the countries included in the in-depth study - Jamaica, Peru, Sri Lanka, Tanzania, and Zambia - reconciliation of the need for adjustment with minimum disruption of development programs would have required the phasing of the adjustment process over a longer period of time, and this, in turn, would have been possible only if adequate financial resources had been available for this purpose.

UNEARNED IMPORT CAPACITY: PERFORMANCE AND POLICIES

The suddenness of the upsurge in world trade prices in 1973-74 faced governments with the need to take immediate

steps to finance the balance of payments deficits that resulted, since it was bound to take some time before measures of adjustment, however far-reaching, could make an impact on external balances. Much depended on the extent to which countries were able to raise substantial new external finance, whether from traditional bilateral and multilateral sources, from private capital markets, or from the oil-exporting countries. Experience in this regard has already been discussed earlier in this chapter.

Those countries able to borrow in private capital markets acquired a certain freedom of action, since, for the time being at least, the conditions for such borrowing did not impinge upon government policies or performance. In fact, the banks were, at times, so liquid that they pressed their loans not only on developing countries with which they had had previous experience but also on a number of other developing countries. Tables 2.4 and 2.5 set out available data on recourse to private capital markets by countries in the sample. As may be seen from these tables, private capital, and particularly bank loans, was a relatively important source of external finance for all countries other than India, Kenya, Sri Lanka, and Tanzania; and was particularly important in the case of Brazil and the Republic of Korea. Bank loans were, however, not without problems. In the first place, the borrowing countries had to provide the requisite guarantees and back those guarantees with their reserves. Brazil, for example, sought to maintain at least one dollar of reserves for every five dollars of foreign debt. The additional cost of this requirement was probably of the order of one percentage point over and above the interest charges on the loans themselves. The Philippines maintained an even higher ratio - by 1976 more than one dollar of reserves for every four dollars of foreign debt. Indeed, had the Central Bank maintained reserves at the level of December 1973, which was already high by historical standards, less than half of the actual foreign borrowing of \$2.3 billion from the commercial loan market from 1974 to 1976 would have been needed. A second difficulty was the short- and medium-term nature of the loans. Thus, apart from the enormous increase in the size of the debt (and, hence, in the proportion of export earnings preempted for debt service), there was a shortening of average debt maturities and a rise in the proportion of loans falling due within five years. In Brazil, for example, the proportion of loans in the latter category rose from 57 percent in 1974 to as much as 72 percent in 1977.

In cases such as the Philippines, recourse to the private capital market was intended to supplement drawings on the IMF, which could provide only a small proportion of the country's total requirements for external finance. However, the Fund's approval of the government's policies was considered

Table 2.4. International Bond Issues and publicized Eurocurrency Credits:
eleven developing countries
(millions of dollars)

	<u>1970^{a/}</u>	<u>1971^{a/}</u>	<u>1972^{a/}</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Brazil	15.5	6.0	121.0	883.1	1629.5	2154.8	3481.6	3119.8
India	-	1.2	-	12.5	-	-	-	50.0
Indonesia	0.3	-	-	192.0	367.5	1625.0	518.6	87.7
Ivory Coast	-	-	-	82.8	63.0	50.0	157.7	226.0
Jamaica	1.2	-	10.0	49.6	95.0	103.0	15.0	32.0
Kenya	-	-	-	4.6	-	-	-	-
Korea, Republic of	3.0	12.0	-	48.2	318.7	325.6	1098.2	695.6
Peru	-	-	-	628.0	362.0	434.3	350.0	91.0
Philippines	-	-	50.0	148.5	870.2	223.1	1240.4	806.8
Uruguay	-	-	-	-	-	130.0	81.5	60.0
Zambia	-	-	-	150.0	-	160.0	-	-

Sources: IBRD, Borrowing in International Capital Markets, various issues, and Annual Report, various issues.

^{a/} Bond issues only.

Table 2.5. Net changes in the claims of US banks on seven developing countries^{a/}
(millions of dollars)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Brazil	72	189	460	330	693	1127	1515	-238
India	4	53	-15	-17	-13	1	13	-16
Indonesia	30	-11	59	7	111	18	-28	14
Korea, Republic of	-33	151	-52	114	552	733	191	359
Peru	-43	-3	66	24	388	179	128	27
Philippines	-46	-75	14	30	157	27	186	-124
Uruguay	-3	-14	-14	11	4	-8	-12	35

Sources: US Treasury Department, Treasury Bulletin, various issues.

^{a/} Claims on Ivory Coast, Kenya, Sri Lanka, Tanzania, and Zambia, which are not reported separately, are believed to be small. Data on claims on Jamaica are not available.

helpful in securing commercial loans, and was conditional on the acceptance of a ceiling on foreign borrowing - an additional safeguard for the banks as well as for the country itself.

As may be seen in table 2.6, bilateral and multilateral concessional flows increased considerably after 1973 to those countries that were unable to borrow from the private capital markets. Indeed, combined concessional flows to India, Kenya, Sri Lanka, and Tanzania more than doubled between 1973 and 1975. For other countries, however, concessional flows advanced little in nominal terms and probably declined in real terms.

A notable feature of the period after 1973 was the emergence of OPEC countries as a source of long-term finance. Such flows were particularly important in the case of India, where they resulted in large part from deferred payment arrangements on oil imports. India also borrowed 2 million tons of wheat from the Soviet Union in 1974-75 to be repaid in kind. Still more significant for the longer run was a rise in net invisible receipts, particularly on account of private remittances, from 1.6 billion rupees in 1973-74 to 4.4 billion in 1974-75 and 7.2 billion in 1976-77. This increase was a result of a number of new policy measures designed to attract deposits and investment by nonresident Indians.

The evidence reviewed in the preceding paragraphs suggests that most countries were able to offset the declines in earned import capacity that occurred after 1973 with higher long-term capital flows. However, table 2.3, which records for 12 countries 'unearned import capacity' (that is, inflows of capital deflated by import prices), shows that in four countries (Jamaica, Kenya, Philippines, and Tanzania) the year in which earned import capacity first fell also witnessed a decline in unearned import capacity. In the Philippines and Tanzania long-term capital subsequently played an important role in sustaining total import capacity, but in Jamaica and Kenya the real value of capital inflows drifted downward continuously after 1973. In the remaining eight countries, the initial declines in earned import capacity were accompanied by increases in long-term capital inflows in real terms, but in no case was the increase sufficient in magnitude to offset completely the fall in earned import capacity. Consequently, aggregate earned and unearned import capacity declined for all 12 countries for at least one year, and for 8 of the 12 countries earned plus unearned import capacity remained below precrisis levels for two years or more.

Table 2.6. Bilateral and multilateral concessional flows^{a/} from DAC and OPEC member countries^{b/} to thirteen developing countries as reported by donor countries and agencies (millions of dollars)

	1970	1971	1972	1973	1974		1975		1976	
					DAC ^{c/}	OPEC ^{d/}	DAC ^{c/}	OPEC ^{d/}	DAC ^{c/}	OPEC ^{d/}
Brazil	136	120	148	114	169		165		113	
India	821	997	614	780	1123	228	1505	210	1393	407
Indonesia	464	588	503	616	663		692		686	
Ivory Coast	53	51	48	63	80		101		109	
Jamaica	11	18	17	19	26		25		30	
Kenya	58	67	72	96	119		129	4	158	
Korea, Republic of	275	324	366	282	252		250		227	
Peru	44	38	63	95	81		74		76	
Philippines	46	70	164	223	158		180		187	1
Sri Lanka	49	55	58	58	81		152	28	129	12
Tanzania	51	61	61	100	162	7	302	7	267	
Uruguay	13	9	24	19	11		13		13	
Zambia	13	22	22	46	63	2	87	13	63	

Source: OECD, Development Cooperation, various issues; UNCTAD, Handbook of International Trade and Development Statistics: 1977 Supplement.

^{a/} The term "concessional" refers to grants and loans containing a grant element of 25 percent or more.

^{b/} Concessional flows from socialist countries of Eastern Europe and from China also played a role in some countries. From 1971 to 1974, for example, two-thirds of the flow of concessional finance to Tanzania was contributed by China. Comprehensive information on such flows is not available.

^{c/} Net disbursements by DAC member countries and by multilateral institutions to which DAC member countries are the principal contributors.

^{d/} Gross disbursements by OPEC member countries and by multilateral institutions to which OPEC member countries are the principal contributors.

THE ROLE OF RESERVES AND PAYMENTS FINANCE

In addition to policies to expand exports and to attract additional long-term capital, governments in all countries used reserves and/or official payments finance to cushion the impact of external pressures on the domestic economy. As may be seen from table 2.7, all 12 countries made net use of IMF credit and/or ran down official reserve holdings during at least one year between 1974 and 1977. Official attitudes toward the use of Fund credit were generally quite cautious. To be sure, as mentioned above, the Philippine authorities found reaching agreement with the Fund helpful in securing commercial loans. Brazil, on the other hand, sought freedom from outside constraints and was prepared, to that end, to incur the additional cost of borrowing from the private market. It was felt that the conditions for Fund accommodation in the upper credit tranches would have imposed their own costs in terms of curtailment of economic activity and a narrowing of the scope for choice among a variety of internal and external policy options, and that such costs might well be a multiple of the additional costs of borrowing from the private capital market. Similar considerations were operative in the Ivory Coast's decision not to draw even on the first credit tranche.

During 1973-74 and 1974-75, India drew a total of 5.5 billion rupees from the Fund under the compensatory financing and oil facilities, and the reserve and first credit tranches. India could have borrowed a maximum of 24 billion rupees under the regular credit tranches and the extended Fund facility, as against the 2.94 billion rupees that were actually drawn under these two headings. The reason for this very limited use was, as in the cases of Brazil and Ivory Coast, unwillingness to be required to conform to the conditions for drawings in the upper credit tranches of the Fund. (For a statement on this matter by the Minister for External Affairs, see Chapter 3.)

Table 2.8, which breaks down use of Fund resources into its principal components, shows that all 11 countries using Fund resources during the period 1974 to 1977 drew primarily from the compensatory financing facility and the oil facility, two sources of Fund credit that carry low levels of conditionality.

The degree of success of countries in shielding the domestic economy from reductions in earned and unearned import capacity through use of reserve assets and official payments finance may be seen in table 2.3. In that table, differences in the behavior of the index 'earned and unearned import capacity' and the index 'total import capacity' reflect the use of reserves and of official payments finance. As may be seen in table 2.3, in only three cases - Ivory Coast, the

Table 2.7. The settlement of payments imbalances^{a/}
(millions of dollars)

	1970	1971	1972	1973	1974	1975	1976	1977
<u>Brazil</u>								
Change in reserves and related items	-574	-536	-2427	-2313	962	1010	-2266	-699
Change in reserves	-552	-531	-2482	-2306	989	1015	-2684	-715
Use of IMF Credit	-	-	-	-	-	-	-	-
<u>India</u>								
Change in reserves and related items	-311	-123	21	108	20	-356	***	***
Change in reserves	-81	-113	21	108	-577	-596	-1701	-2110
Use of IMF Credit	-230	-10	-	-	598	244	-377	-320
<u>Ivory Coast</u>								
Change in reserves and related items	-39	15	66	6	-61	84	-30	-110
Change in reserves	-41	18	65	0	-71	85	-37	-100
Use of IMF Credit	-	-	-	-	13	-	14	-11
<u>Jamaica</u>								
Change in reserves and related items	-21	-26	25	30	-70	74	261	4
Change in reserves	-21	-26	25	14	-70	44	120	-16
Use of IMF Credit	-	-	-	15	-	-	65	27
<u>Kenya</u>								
Change in reserves and related items	-51	65	-29	-21	88	49	-85	-279
Change in reserves	-51	65	-29	-21	49	4	-105	-236
Use of IMF Credit	-	-	-	-	38	45	20	-44
<u>Korea, Republic of</u>								
Change in reserves and related items	-57	42	-169	-349	172	-376	-1316	-1370
Change in reserves	-57	42	-169	-349	40	-506	-1413	-1346
Use of IMF Credit	-	-	-	-	132	130	97	-24

Table 2.7. (continued)

	1970	1971	1972	1973	1974	1975	1976	1977
<u>Peru</u>								
Change in reserves and related items	-299	35	-23	-94	399	497	369	2
Change in reserves	-281	42	-52	-74	-382	497	137	-74
Use of IMF Credit	-18	-7	29	-20	-17	-	231	76
<u>Philippines</u>								
Change in reserves and related items	-83	-125	-202	-668	-590	-4	58	26
Change in reserves	-97	-146	-208	-645	-581	-121	-157	-56
Use of IMF Credit	14	21	7	-23	-10	118	212	82
<u>Sri Lanka</u>								
Change in reserves and related items	-17	-10	-30	-29	18	25	-57	-210
Change in reserves	-3	-3	-35	-27	-16	-1	-67	-251
Use of IMF Credit	-15	-7	3	-1	34	27	10	50
<u>Tanzania, United Republic of</u>								
Change in reserves and related items	15	9	-55	-32	137	16	-22	-161
Change in reserves	15	9	-55	-32	90	-13	-46	-164
Use of IMF Credit	-	-	-	-	47	29	24	4
<u>Uruguay</u>								
Change in reserves and related items	18	5	8	-37	52	50	-77	-178
Change in reserves	9	8	-21	-25	11	7	-99	-144
Use of IMF Credit	9	-1	22	-5	38	44	29	-26
<u>Zambia</u>								
Change in reserves and related items	-145	253	141	12	-10	79	72	39
Change in reserves	-145	235	121	-11	-10	56	51	26
Use of IMF Credit	-	19	21	23	-	23	22	5

Source: IMF, Balance of Payments Yearbook: Supplement to Vol. 28 (December 1977);
IMF, International Financial Statistics (various issues).

2/ Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.8. Net Use of IMF Credit^{a/}
(millions of dollars)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
<u>Brazil</u>								
CFF	-	-	-	-	-	-	-	-
Oil Facility	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-
<u>India</u>								
CFF	-	-	-	-	76	-3	-	-
Oil Facility	-	-	-	-	245	225	-236	-11
Other	-230	10	-	-	277	22	-141	-309
<u>Ivory Coast</u>								
CFF	-	-	-	-	-	-	15	1
Oil Facility	-	-	-	-	13	-	12	-11
Other	-	-	-	-	-	-	-13	-1
<u>Jamaica</u>								
CFF	-	-	-	-	16	-	31	2
Oil Facility	-	-	-	-	-	-	34	-
Other	-	-	-	15	-16	-	-	25
<u>Kenya</u>								
CFF	-	-	-	-	-	-	28	1
Oil Facility	-	-	-	-	39	32	3	40
Extended Facility	-	-	-	-	-	9	-	-
Other	-	-	-	-	-1	4	-11	-85
<u>Korea, Republic of</u>								
CFF	-	-	-	-	-	-	47	2
Oil Facility	-	-	-	-	110	121	63	12
Other	-	-	-	-	22	9	-13	-38

<u>Peru</u>								
CFF	-	-	33	-17	-	-	71	3
Oil Facility	-	-	-	-	-	-	61	3
Other	-18	-7	-4	-3	-17	-	52	70
<u>Philippines</u>								
CFF	-	-	-	47	-11	-2	56	4
Oil Facility	-	-	-	-	-	113	64	8
Extended Facility	-	-	-	-	-	-	105	89
Other	14	21	7	-70	1	7	-13	-19
<u>Sri Lanka</u>								
CFF	-	-18	2	23	8	-12	5	-17
Oil Facility	-	-	-	-	42	34	14	3
Other	-15	11	1	-24	-16	5	-9	64
<u>Tanzania, United Republic of</u>								
CFF	-	-	-	-	-	-	24	2
Oil Facility	-	-	-	-	35	26	-	-
Other	-	-	-	-	12	3	-	2
<u>Uruguay</u>								
CFF	-5	-1	16	1	-	-6	20	-4
Oil Facility	-	-	-	-	57	40	13	-1
Other	14	-	6	-6	-19	10	-4	-21
<u>Zambia</u>								
CFF	-	21	21	5	1	-2	-1	25
Oil Facility	-	-	-	-	-	22	12	2
Other	-	-2	-	18	-1	3	11	-22

Source: IMF, International Financial Statistics (various issues).

a/ Purchases less repurchases. Minus sign indicates net repurchases.
CFF denotes Compensatory Financing Facility.

Republic of Korea, and the Philippines - were countries able to avoid altogether declines in import capacity through reserve management. Although the data in table 2.3 show a decline in the import capacity of Brazil after 1974, the surge in imports in 1974, made possible by substantial use of reserves, was associated with large-scale accumulation of inventories that were subsequently drawn down.

In two other cases (Jamaica and Sri Lanka) reserve management allowed countries to avoid declines in import capacity during the first year in which they occurred, but subsequent declines in earned and unearned import capacity, which in the case of Jamaica were sizeable, could not be countered to the same extent. In the remaining countries it was possible to cushion in varying degrees declines in earned and unearned import capacity by recourse to reserve changes and payments finance. In no case in which two consecutive annual declines in earned and unearned import capacity occurred was a country able to deploy resources during the second year of decline sufficient to duplicate the degree of offset achieved during the first year. Moreover, the capacity for sustained use of reserves and payments financing was particularly weak in those countries that had previously encountered difficulties in generating or maintaining growth of import capacity. In Jamaica, for example, the reserve to import ratio stood at three percent in 1976, and Sri Lanka, Tanzania, and Zambia also recorded ratios below 10 percent for at least one year during the period 1974 to 1977.

Thus, despite the measures taken by the international community to enhance the availability of official balance of payments finance, the breathing space available to most countries to mobilize increased amounts of external long-term capital and to effect improvement in export earnings was extremely short. When changes in long-term capital flows and export performance of the magnitude required proved infeasible within a one- or two-year period, adjustment was forced upon the countries concerned through curtailment of their imports.

TRADE POLICIES TO DEAL WITH REDUCED IMPORT CAPACITIES

The imperative need for curtailing imports led many countries to impose or strengthen direct controls on imports as the swiftest and surest means for that purpose. Only the Ivory Coast (where adjustment in the trade balance through import compression did not occur in 1974-76), Indonesia, and Uruguay did not intensify existing import restrictions or introduce new ones.

In 1975-76, Brazil prohibited imports of about 300 "superfluous" items, doubled tariff rates for some 1,200 items,

and raised the rates on 800 other items by 30 percent. A 100 percent import deposit - refundable without interest after 360 days - was introduced on approximately 30 percent of the import bill, equivalent to an additional cost of about 50 percent of the value of imports at current interest rates. Strong measures were adopted to promote import substitution, including a program for self-sufficiency in basic inputs and development of a domestic capital goods industry. In India, likewise, quantitative controls were made more restrictive, and except in certain priority industries, import licenses for industry were cut drastically. An explicit export-import link was introduced so that import entitlements were made to vary directly with export performance. A similar link was applied in Brazil to the major foreign companies operating in the country. In Zambia, the government withdrew all outstanding import licenses for examination and selective revalidation in January 1975. The impact on imports was dramatic but did not become apparent until 1976. Consequently, exchange restrictions were tightened in September 1975 affecting travel expenditure and remittances of profits, dividends, and expatriate salaries. In 1976, the volume of imports dropped to 60 percent of the 1970-72 level. Kenya has traditionally maintained a liberal trade and payments regime and was most reluctant to resort to quota restrictions. Even here, however, the real value of import licenses issued was reduced by nearly one-third from 1974 to 1975. Like Brazil, Tanzania regarded the crisis not only as an occasion to restrict imports, but also as an opportunity to press forward a strategy of industrial import substitution "in depth," including certain elements of the engineering industry as well as shoes, textiles, bicycles, and cement. In Uruguay, on the other hand, import policies were extensively liberalized during this period and, in particular, import quotas and other restrictions were abolished in 1975. Deflationary policies, nevertheless, resulted in a decline in the volume of imports in 1974-75, mainly affecting inventories.

As may be inferred from this rather extensive recourse to import restraints, and from the difficulties experienced by many countries in expanding exports, very few of the countries studied were able simultaneously to improve their trade balances and expand their capacity to import. As may be seen from table 2.9, between 1974 and 1976 only India, the Ivory Coast, the Republic of Korea, and Uruguay were able to combine improvement in the trade balance with an expansion of import capacity; and in the case of Uruguay, the rise in import capacity between 1974 and 1976 followed a sharp drop in 1974 of greater magnitude than the subsequent recovery. Four other countries - Brazil, Kenya, Sri Lanka, and Tanzania - recorded improvements in the trade balance over that period, but this adjustment was accompanied by a

fall in import capacity. (As noted earlier, the drop in Brazil's import capacity between 1974 and 1976 followed a sharp increase in imports in 1974 associated mainly with inventory accumulation. The decline in Brazil's import capacity, therefore, did not have the same implications as regards the effective availability of imported goods as did the declines in the other countries.) Peru and the Philippines generated increases in import capacity, primarily by borrowing abroad and widening their trade deficits in the process, while in Jamaica and Zambia deteriorations in the trade account were accompanied by declines in import capacity. Finally, Indonesia recorded a sizeable trade surplus throughout this period and had already registered a substantial increase in import capacity in 1974. Between 1974 and 1976 the trade surplus was reduced somewhat and import capacity expanded.

Although the pattern of changes in trade balances and in import capacity shifted somewhat in 1977, the overall picture that emerges from the data presented in table 2.9 is very much the same: a relatively small number of countries - in this case Brazil, the Ivory Coast, and the Republic of Korea - were able to adjust their trade balances in the context of growing command, in real terms, over goods and services from abroad. In Jamaica, Kenya, Peru, and Sri Lanka improvement in the trade balance could not be achieved through an expansion of exports sufficiently rapid to allow import capacity to advance; while Tanzania, Uruguay, and Zambia (the latter for the second year running) suffered both a deterioration in trade balances and a fall in import capacity.

The evidence reviewed in the preceding paragraphs points to serious shortcomings in the operation of the adjustment process from 1974 to 1977. In the first place, too little of the adjustment of deficits took the form of rising exports. This was due partly to the relatively limited capacity of a number of developing countries to raise their earnings from traditional exports and/or to develop new types of export. But it was due also to the general slackness of world markets and protectionist policies that depressed the demand for products exported by developing countries, and, in some cases, the prices of these products. What was required, in these circumstances, was the provision of financial support on a scale sufficient to permit the necessary adjustments to be made in a context of growth, thus tiding over the effects of unfavorable and reversible world market conditions. The financial support that was forthcoming was, however, insufficient, despite considerable expansion and innovation in the provision of official payments finance. Consequently, in most countries an inordinate share of the burden of adjustment fell on imports, and import compression became a significant avenue through which external disturbances were transmitted to the domestic economy, thereby disrupting the development

Table 2.9. Changes in trade balances and in import capacity: 1974-77

	Trade Balance (millions of dollars)		Change in trade balance ^{a/} (millions of dollars)		Change in import capacity ^{b/} (percent)		Change in trade balance ^{a/} (millions of dollars)		Change in import capacity ^{b/} (percent)	
	1974	1976	1974	1977	1974 to 1976	1976 to 1977	1974 to 1976	1976 to 1977	1974 to 1976	1976 to 1977
Brazil	-6,127	-3,576	-1,089		2,641		-25	2,487	30	
India	-1,120	-81	-188		1,039		25 ^{c/}	-107	10 ^{c/}	
Indonesia	3,584	2,874	4,623		-710		19	1,749	6	
Ivory Coast	245	335	646		90		24	311	8	
Jamaica	-205	-280	-118		-75		-5	162	-30	
Kenya	-423	-183	-104		240		-13	79	-4	
Korea, Republic of	-2,392	-1,059	-764		1,333		36	295	24	
Peru	-11	-735	-316		-724		15	419	-2	
Philippines	-756	-1,425	-1,173		-669		30	252	1	
Sri Lanka	-192	-9	57		183		-8	66	-1	
Tanzania	-352	-149	-219		203		-20	-70	-5	
Uruguay	-105	-42	-70		63		48	-28	-24	
Zambia	422	242	81		-180		-27	-162	-22	

Source: United Nations, based on IMF, International Financial Statistics (various issues).

^{a/} Minus sign indicates increase in deficit or reduction in surplus.^{b/} The sum of earnings from export of goods and services, net receipts of transfers and long-term capital, and changes in reserves and related items less gross payments on account of investment income. This sum is then deflated by changes in import prices.^{c/} Merchandise export earnings deflated by import prices.

process, as will be shown in the course of the discussion that follows. Moreover, since the shortfall in official balance of payments support could be made good only through recourse to borrowing from private capital markets, the burden of adjustment weighed most heavily on those countries unable to secure access to these markets - generally the poorest of the developing countries.

THE IMPACT OF EXTERNAL FACTORS ON THE DOMESTIC ECONOMY

The routes through which developments affecting the external account work through the domestic economy are many and varied. It will not be possible, in the course of this general review, to present a comprehensive account of the interrelationship between external factors and all aspects of the domestic economy. An attempt will, however, be made to examine the more important avenues of influence on the domestic economy and, in particular, those having a direct bearing on levels of economic activity, welfare, and future growth. The preceding section focused attention on three separate but highly interrelated areas: the evolution of import and export prices; the deterioration in trade and current account balances; and the reduction in import capacity. The present section examines, again, the changes in prices of traded goods and in import capacity, and traces their impact on the domestic economy.

The changes in prices discussed in the preceding section impinged on the domestic economy in two ways. Changes in the terms of trade had a direct impact on the gains from trade, that is, on the advantages derived by countries from exchanging domestic output for goods and services produced abroad. In addition, changes in the level of import prices had a cost-push effect on the domestic price level, thereby aggravating the problem of price inflation. Changes in the terms of trade, when they occur over a relatively short period of time, may be assumed to reflect rather directly changes in a country's gains from trade. When the change in relative prices of imports and exports occurs over a short period of time, it can generally be assumed that techniques of production and, therefore, the value of domestic resources used to produce a unit of exports have remained unchanged. The argument also assumes that there is limited substitutability between imports and exports in both consumption and production. Rough estimates have been made of the apparent impact on national income of changes in the terms of trade. The magnitude of this impact depends on the extent of the change in the relative prices of imports and exports, the size

of the trade surplus or deficit relative to imports, and the importance of imports relative to GNP(6). Table 2.10 sets out the magnitude of these variables. In making the calculations in that table, the average level of prices during the period 1974 to 1976 was compared with the level of prices in 1971, and the trade structure and size of imports relative to GNP used were those of 1972-73. The final column records the magnitude of the impact of price changes on national income, expressed as a percentage of national income. This figure represents the once-for-all gain or loss resulting from the change in prices between 1971 and the average of 1974 to 1976. As may be seen from this table, nine of the 13 countries experienced losses ranging in magnitude between 4 and 20 percent of national income. As would be expected, negative price movements had a particularly severe impact on countries with a high ratio of international trade to GNP. Thus, four countries suffering from adverse price movements (Jamaica, Kenya, Republic of Korea, and Tanzania) had ratios of imports to GNP of 20 percent or more; all of them suffered terms of trade losses equal to 10 percent or more of national income. At the other end of the scale, Brazil and India, where imports amount to less than 10 percent of GNP, suffered a deterioration in the gains from trade amounting to less than 5 percent of gross national income. Indonesia, Ivory Coast, Peru, and Zambia show increases in the gains from trade as a result of the price changes. The outcome for Peru and Zambia would be considerably less favorable, however, if the period over which price changes were measured had been extended to include 1977, a year in which copper prices fell.

Thus, for a large number of the countries studied, adverse price movements resulted in a once-for-all 'writing down' of national effort, that is, of the value of domestic labor, capital, and raw materials. To be sure, the downward impact on national income resulting from diminished gains from trade was spread over the three-year period 1974 to 1976. Nonetheless it had an important bearing on economic performance in those countries in which it occurred.

The analysis presented above is purely 'static,' in that it assumes a constant level of domestic expenditure and constant volumes of imports and exports. In practice, any reduction in real income will exert a deflationary impact on expenditure as purchasing power is reduced. Unless countervailing measures are taken, or there are other sources of expansionary strength in the economy, the reduction in expenditure will lead to a decline in output and investment. Given the sensitivity of the demand for imports to changes in expenditure and output, the volume of imports, including raw materials and capital goods, will fall. Therefore, there will be a tendency to reestablish balance in the current account, albeit at lower levels of real output. A second mechanism linking the external accounts and

Table 2.10. The effect of trade on gross national income
(Percentage)

Country	Increase in export prices ^{a/}	Increase in import prices ^{b/}	Export earnings as a percentage of the import bill ^{c/}	Imports as a percentage of the national income ^{d/}	The influence of terms of trade changes on national income ^{e/}
Brazil	82.0	120.0	85.0	9.0	-4.5
India	82.1	186.0	97.7	4.0	-4.2
Indonesia	318.7	82.2	121.9	15.6	49.3
Ivory Coast	80.8	36.6	125.5	27.0	17.5
Jamaica	114.1	135.4	70.0	29.8	-16.5
Kenya	104.7	138.2	80.8	24.2	-13.0
Republic of Korea	34.0	98.4	81.3	27.6	-19.5
Peru	91.6	74.8	107.8	11.3	2.7
Philippines	91.0	126.0	105.3	15.1	-4.6
Sri Lanka	85.5	163.9	98.3	14.1	-11.3
United Republic of Tanzania	117.1	149.4	98.3	23.3	-11.6
Uruguay	48.1	159.0	142.6	8.5	-7.7
Zambia	43.8	52.8	172.0	59.0	13.3

Source: United Nations.

a/ The change in the export price index between 1971 and the annual average for 1974-76, expressed as a percentage of the value of the index in 1971.

b/ The change in the import price index between 1971 and the annual average for 1974-76, expressed as a percentage of the value of the index in 1971.

c/ The value of merchandise exports in 1972 and 1973 as a percentage of the value of merchandise imports for the same two years.

d/ The value of merchandise imports in 1972 and 1973 as a percentage of gross national income for those two years.

e/ Calculated from the formula:

$$dY/Y = - (P_m/M/Y)(dP_m/P_m - adP_x/P_x)$$
, where $a = P_x X/P_m M$, and where Y = real gross national income, E = real domestic expenditure, P_x and P_m = prices of exports and imports, respectively and X and M = quantum of exports and imports, respectively. Minus sign indicates decline in real gross national income.

the domestic economy operates through the compression of imports, particularly of 'developmental' imports, below the volume that would normally be required at current levels of activity. Reductions in imports of raw materials and intermediate goods may make it impossible to maintain utilization of productive capacity at levels warranted by the current volume of demand, while curtailment of imports of capital goods causes shortfalls in planned investment.

At first sight, the implications of these two mechanisms through which disturbances in the external accounts affect levels of activity would appear to be quite different. If the first mechanism were assumed to be dominant, the observed reduction or slackening in imports would be the consequence of a slower pace of activity. On the other hand, if the second mechanism were assumed to be dominant, the reduction or slackening in imports would itself be the cause of the slower pace of activity. From a policy standpoint, however, this distinction is not likely to have been of great significance during the period dealt with here. It will be evident from the analysis in the preceding section that difficulties were being experienced by almost all countries in generating a growing capacity to import; in these circumstances, policy actions to offset the deflationary impact of the increased import bill would rapidly encounter constraints on the external side. Thus, whichever mechanism dominated, foreign exchange availabilities were, directly or indirectly, an effective constraint on growth. The data do not make it possible in practice to separate out the operations of the two mechanisms. In either case, what is observed is a reduction in imports of raw materials and capital goods below 'normal' levels, coupled with a slackening of activity, primarily with regard to industrial output and investment.

In addition to the deflationary influence of the terms of trade on expenditure and output, the compression of developmental imports was also a common occurrence among the 13 countries during the period 1974 to 1976. While such compression was related to the changes in import capacity discussed in the preceding section, a fall in import capacity does not necessarily lead to a compression of developmental imports if other categories of imports can be reduced. This was indeed the experience of the Ivory Coast and Uruguay during this period. Similarly, a small advance or mild contraction of import capacity can be associated with a significant drop in developmental imports if imports of essential consumer goods such as basic foodstuffs must be increased simultaneously, as was the case in India.

From 1974 to 1976 reductions in the volume of developmental imports from levels attained in 1972-73 occurred in five of the countries studied (India, Jamaica, Kenya, Sri Lanka, Zambia). In three other countries (Brazil, Peru, United Republic of Tanzania) the rate of advance in the volume of developmental imports has been judged to be below that required to maintain a reasonable and feasible rate of GDP growth. In the remaining five countries (Indonesia, Ivory Coast, Republic of Korea, Philippines, Uruguay), no shortfall in the availability of developmental imports was observed.

These phenomena appear to be directly related to overall economic performance. The eight countries that experienced import compression also experienced marked declines in growth rates. If one groups together the two or three years following significant deterioration in the trade account in which growth performance was weakest (including 1977 in the case of Peru and Zambia, which encountered serious difficulties in maintaining growth somewhat later than the other countries) the unweighted average rate of GDP growth for these eight countries was two percent, as compared with 6.3 percent from 1970 to 1973. For the remaining five countries, however, rates of growth did not fall on average, although Indonesia and the Ivory Coast did experience one year in the post-1973 period in which the rate of growth was below the worst rate achieved between 1970 and 1973.

A broader picture of the economic performance of the two groups of countries from 1974 to 1976 is presented in table 2.11, which records rates of growth of GDP and its principal components. As may be seen from that table, the economic performance of countries that experienced continued growth of developmental imports was, on the average, somewhat improved from 1974 to 1976 as compared with previous periods. With regard to GDP performance, this pattern also held for each individual country in the group, except for Indonesia where growth rates declined in the latter period, and the Republic of Korea where, on average, they remained virtually unchanged. Particularly important was the acceleration of domestic investment, notably in the Republic of Korea, the Philippines, and Uruguay. In the Republic of Korea this was accompanied by lower rates of expansion of personal consumption, and in Uruguay by a decline in personal consumption. In sectoral terms, higher growth rates of agricultural output were noteworthy.

As may be seen further from table 2.11, the average performance between 1974 and 1976 of the group of countries that experienced import compression was below the level of the preceding three-year period. There were exceptions, however: growth performance in Sri Lanka improved in virtually all respects during this period, supported by a substantial increase in the rate of growth of agricultural

Table 2.11. Import Capacity and Economic Performance: Thirteen Developing Countries

	(average annual rates of growth) ^{a/}									
	GDP ^{b/}		Gross Domestic Investment ^{c/}		Government Consumption ^{c/}		Personal Consumption ^{c/}			
	1965-73	1970-73	1974-76	1965-73	1970-73	1974-76	1965-73	1970-73	1974-76	1965-73 1970-73 1974-76
Countries with no significant compression of imports during 1974-76 ^{d/}	5.8	6.7	7.0	12.1	9.6	12.5	7.6	9.1	8.2	4.9 5.6 4.0
Countries experiencing significant compression of imports during at least part of 1974-76 ^{e/}	6.0	6.3	4.2	10.5	7.5	1.5	8.7	9.9	5.4	5.0 4.8 4.1
	Agricultural Output ^{c/}			Manufacturing Output ^{c/}			Mining and Quarrying Output ^{c/}			
	1965-73	1970-73	1974-76	1965-73	1970-73	1974-76	1965-73	1970-73	1974-76	
Countries with no significant compression of imports during 1974-76 ^{d/}	3.1	3.4	5.2	9.9	11.5	9.8	11.9	15.5	4.2	
Countries experiencing significant compression of imports during at least part of 1974-76 ^{e/}	2.7	2.7	3.6	8.2	9.9	5.4	6.0	2.8	0.4	

Source: United Nations.

^{a/} Average of year-to-year changes for the periods indicated.

^{b/} Unweighted averages.

^{c/} Averages across countries of sectors and categories of expenditure have been weighted by the share of the sector or category in the GDP of the country concerned.

^{d/} Indonesia, Ivory Coast, Republic of Korea, Philippines, Uruguay.

^{e/} Brazil, India, Jamaica, Kenya, Peru, Sri Lanka, United Republic of Tanzania, Zambia.

output; and the rate of advance of GDP increased in Tanzania also, again owing to stronger performance by the agricultural sector. Aside from Sri Lanka, all countries in this group experienced lower rates of expansion of personal consumption, domestic investment, and manufacturing output between 1974 and 1976 than in the earlier period. The sharp deterioration in the rate of advance of domestic investment is particularly disturbing, since it indicates that the expansion of productive capacity has been drastically curbed. In India and Kenya, a decline in the rate of advance of agricultural output contributed to the poorer overall economic performance. In all other cases, there must be a strong presumption that the external forces described earlier played a predominant role, although in Peru these did not make themselves felt until the very end of the period.

PRICES AND REAL WAGES

During the period 1966 to 1970, the rate of price inflation varied considerably among the 13 countries, with average annual rates of increase in GDP deflators ranging from 2.1 percent in the United Republic of Tanzania and 2.3 percent in Kenya to 52 percent in Uruguay and 66 percent in Indonesia. In the course of this same period, the rates of price inflation moderated in five of these countries (Indonesia, Peru, Uruguay, Zambia and, to a lesser extent, Brazil), were relatively stable in another five (India, Kenya, Republic of Korea, Sri Lanka, Tanzania), and moved upward in the remaining three (Ivory Coast, Jamaica, Philippines). Thus, for the great majority of the group, 1966 to 1970 were years of moderating or declining rates of price inflation.

During 1971-72, this general tendency was reversed, with seven of the countries experiencing acceleration in rates of price inflation, and in 1973 the rate of inflation, as measured by the GDP deflator, accelerated in all of the countries except for the Republic of Korea, Tanzania, and Zambia (see table 2.12). (In order to provide as close a measure as possible of price changes in the domestic economy, that component of the GDP deflator relating to exports has been excluded, and the remaining component prices indexes reweighted. The resulting overall deflator, changes in which are recorded in table 2.12, measures the weighted average prices of all categories of expenditure other than exports). The widespread tendency for price inflation to accelerate was associated with a number of underlying factors. In a large number of countries, there were increases in aggregate demand pressures, fueled in part by the rapid expansion in export earnings that occurred in most countries during this period. Where full utilization of

Table 2.12. Import Prices and Domestic Price Inflation

(annual percentage rates of change)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
<u>Brazil</u>						
Change in GDP deflator	16.6	17.4	20.0	30.4	31.6	40.9
Weighted change in import prices	0.6	0.5	2.1	6.5	0.1	0.1
<u>India</u>						
Change in GDP deflator	3.7	10.9	18.8	19.4	-4.2	2.0
Weighted change in import prices	0.3	0.3	0.2	2.6	4.4	1.0
<u>Indonesia</u>						
Change in GDP deflator	1.2	17.2	31.7	29.6	17.7	17.3
Weighted change in import prices	0.9	1.1	2.9	3.3	1.0	0.2
<u>Ivory Coast</u>						
Change in GDP deflator	3.3	3.1	4.5	14.5	8.5	14.1
Weighted change in import prices	3.4	-5.5	4.9	9.3	2.3	4.7
<u>Jamaica</u>						
Change in GDP deflator	10.2	5.5	27.6	24.1	13.1	18.2
Weighted change in import prices	2.5	1.4	11.3	14.2	3.5	1.2
<u>Kenya</u>						
Change in GDP deflator	5.8	5.8	10.0	4.7	8.9	14.7
Weighted change in import prices	2.2	2.8	4.4	14.8	6.2	2.0
<u>Korea, Republic of</u>						
Change in GDP deflator	11.0	14.2	3.8	22.1	27.7	25.0
Weighted change in import prices	1.6	1.6	6.7	12.8	1.4	1.2

(continued)

Table 2.12. (continued)

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
<u>Peru</u>						
Change in GDP deflator	6.7	6.7	9.7	12.5	25.0	33.6
Weighted change in import prices	0.6	0.9	2.5	4.6	2.0	0.9
<u>Philippines</u>						
Change in GDP deflator	13.7	9.0	12.6	25.9	10.8	9.2
Weighted change in import prices	0.3	0.7	4.5	13.0	0.8	-0.2
<u>Sri Lanka</u>						
Change in GDP deflator	2.0	6.6	11.1	2.4	16.0	2.3
Weighted change in import prices	1.1	0.8	4.6	14.1	3.2	-2.0
<u>Tanzania, United Republic of</u>						
Change in GDP deflator	3.0	8.3	7.1	17.8	15.5	13.4
Weighted change in import prices	2.0	1.8	5.1	10.4	1.9	0.7
<u>Uruguay</u>						
Change in GDP deflator	22.7	62.0	106.0	80.8	80.2	49.5
Weighted change in import prices	-0.9	-0.3	3.2	15.2	1.0	-0.8
<u>Zambia</u>						
Change in GDP deflator	6.6	6.0	0.9	1.6	4.9	4.0
Weighted change in import prices	1.5	1.7	3.2	8.1	7.3	0.7

Source: United Nations, based on information provided in the country studies.

Note: GDP deflator excludes exports. Changes in import prices are weighted by the share of imports in total supplies.

capacity was being approached - as was the case, for example, in Brazil - these pressures were translated rather directly into an acceleration in the rate of increase in prices. In many cases, poor food crops also contributed to the increase in the upward pressure on prices. In 1972, per capita food production fell in 11 of the 13 countries, and in 1973 in seven of the 13, of which five had also experienced declines in 1972. Although the link between food production and availabilities was loosened by national stockpiling policies and imports, the shortfalls in production imparted considerable upward momentum to food prices in most of these countries. Partial exceptions to this rule were Sri Lanka and Tanzania, where the governments were subsidizing food consumption, so that upward pressures on food prices were absorbed, in part, by these subsidies. The subsidies were, however, reflected in correspondingly higher government expenditures and deficits. The food subsidies in Tanzania were a temporary phenomenon and had been fully terminated by late 1974. Finally, in a few countries (Ivory Coast, Kenya, the Republic of Korea, and Tanzania) the upward movement of import prices in 1973 was beginning to impinge significantly on overall price movements.

Except for Indonesia, Jamaica, Kenya, Sri Lanka, and Uruguay, all countries experienced an acceleration in price inflation in 1974, and in some cases the acceleration was quite sharp. In four countries - India, Indonesia, the Philippines, and Tanzania - inflation rates began to subside in 1975. Inflation rates also declined in 1975 or 1976 in the Ivory Coast, Jamaica, and Uruguay, but increased again thereafter. In Brazil, Kenya, and Peru, the rates of price inflation accelerated in 1975 and 1976.

Periodic crop failures continued to exert an inflationary impact in the countries where they occurred. The other elements underlying price behavior, however, changed radically in relative importance. As may be seen from table 2.12, import prices became an important source of upward pressure on the general price level. The line for each country in that table entitled "Weighted change in import prices" indicates the change that would have occurred each year in the average price of total supplies (i.e., GDP plus imports) if the only price change had been in imports. It will be seen that the rise in the general level of prices brought about in 1974 by the increase in import prices alone was equivalent to a third or more of the increase in the GDP deflator in nine of the countries examined (Ivory Coast, Jamaica, Kenya, Republic of Korea, Peru, Philippines, Sri Lanka, Tanzania, Zambia).

The full impact of import price increases cannot, however, be determined simply on the basis of the contribution of such increases to changes in the GDP deflator calculated in static terms. Increases in import prices on the scale that

occurred in 1973-74 generally initiated cost spirals, with spread effects to sectors of the economy not dependent on imports to any appreciable extent. Thus, cost-push pressures from imports had a major effect in virtually all countries except India, where imports are equivalent to only seven percent of GDP. The price changes associated with these cost-push pressures had an important influence on real wage rates and earnings. As may be seen from table 2.13, the period from 1974 to 1977 gave rise to declines in real wage rates or earnings in all countries other than Brazil, Jamaica, the Republic of Korea, and Sri Lanka. Moreover, in Jamaica and Peru the impact of external factors and adjustment policies on real wages was just beginning in 1977, the last year for which data are available; further declines in real wages probably occurred in both these countries in 1978.

The period of payments imbalance and adjustment, thus, was accompanied by a reduction in the welfare of significant segments of the population of the countries studied, and in some cases this reduction was exceptionally steep. In several countries, the rates of decline in real wages were unprecedented, amounting in some cases to as much as 20 to 40 percent. Although direct evidence is lacking, there is a strong presumption that in many countries the reduction was accompanied by a deterioration in the distribution of income.

MACROECONOMIC POLICIES

All of the countries included in the study sought to maintain the momentum of their economies in the face of the external disturbances to which they were exposed. However, they faced problems of unusual complexity in doing so. In the first place, in several countries domestic pressures had begun to build up even prior to the onset of the crisis, and it would have been necessary to deal with these pressures in any case. Secondly, while the upsurge in import prices generated cost inflation accompanied by speculative demand for commodities in expectation of further price increases, the associated expansion of import surpluses resulting from the deterioration in the terms of trade had a deflationary impact on demand, thus creating cross currents in the economy and shifting targets for policymakers. The most serious difficulties of all, however, occurred in those cases where sharp deteriorations in terms of trade led to severe pressures on the balance of payments and on reserves, except where countries were able to obtain access to sufficient finance to offset these pressures.

A few countries (particularly Brazil, the Ivory Coast, and the Republic of Korea) found themselves in a sufficiently strong position to avoid any major interruption of the generally

Table 2.13. Indexes of Real Wages and Earnings
(1972 = 100)

	1971	1972	1973	1974	1975	1976	1977
<u>Brazil</u>							
Average real monthly wage in manufacturing	95	100	105	107	116	126	...
Average real rural monthly wage	100	100	111	130	133	134	...
<u>Indonesia</u>							
Minimum wage rates for industrial workers	...	100	98	107	90	89	...
<u>Ivory Coast</u>							
Minimum real guaranteed non-agricultural wage rate*	...	...	100	97	...	97	...
Minimum real guaranteed wage rate on plantations*	...	...	100	77	...	96	...
<u>Jamaica</u>							
Median real weekly income of income earners in the labor force*	...	...	100	116	124	128	118
<u>Kenya</u>							
Average real annual earnings	...	100	95	90	88	92	...
<u>Korea, Republic of</u>							
Real wage rate in manufacturing	98	100	114	125	126	149	...
<u>Peru</u>							
Real wages in Lima in enterprises with 10 or more employees	91	100	109	102	102	107	86
<u>Philippines</u>							
Real wage rates in Manila, unskilled	104	100	90	73	73	72	70
Real wage rates in Manila, skilled	105	100	92	76	73	71	73
<u>Sri Lanka</u>							
Real wage rate, private sector	102	100	105	115	125	124	...
Real wage rate, public sector	105	100	96	93	99	103	...
<u>United Republic of Tanzania</u>							
Average real monthly wage rate, all sectors	...	100	99	121	99	93	...
<u>Uruguay</u>							
Real wages	121	100	98	97	89	84	74
<u>Zambia</u>							
Real annual average cash earnings, excluding mining industry	...	100	100	92	86	...	...

Source: United Nations, Country Studies.

*1973 = 100.

upward course of the economy; and others, such as Peru, did not experience any immediate setback. Brazilian monetary and fiscal policy was at first cautious in 1974, so that demand growth decelerated while price increases accelerated in the anticipated pattern. Unwilling to permit the development of the recession to compound the other problems confronting it, the government decided to expand aggregate demand in order to stimulate production and employment, and to limit the balance of payments deficit in the short run by means of tight import controls and in the medium run by programs of export promotion and import substitution. By the end of 1976, the government concluded that demand expansion had gone too far and was beginning to intensify cost pressures resulting from the import restrictions. A strategy of progressive deceleration was adopted, with the objective of maintaining annual GDP growth in the neighborhood of five percent through 1980.

In the Ivory Coast, an upturn in the demand for exports, especially coffee, cocoa, and lumber, and the reduction of dependence on imported rice, sugar, and other foodstuffs, created a situation in which policies could be expansionist, despite unfavorable world economic conditions. Nevertheless, moderate constraints were applied by limiting government recourse to bank credit and reducing the rate of growth in domestic credit, the objective being to lower the current account deficit in the balance of payments. However, sufficient credit was provided to facilitate the expansion of agricultural output. In 1975, the current account deficit increased sharply and the basic balance also moved into deficit. This led to more active credit restraint and an increase in the rediscount rate of the Central Bank from 5.5 to 8 percent. These measures contributed to slowing down the rate of expansion of the economy in 1975. Over the period from 1974 to 1977 as a whole, however, credit policy was generally accommodating. This was made possible by the strength of the foreign trade sector and the continuing influx of long-term capital.

In the Republic of Korea, the government's policy provided for stepping up the volume of investment and maintaining an adequate supply of essential imports, which, in turn, called for a high level of foreign borrowing. Supported by massive inflows of foreign capital, which rose from less than \$0.3 billion in 1973 to about \$2 billion in 1974 and 1975, the ratio of gross investment to GNP reached a record level of 31 percent in 1974 and 27 percent in 1975 compared to 24 percent from 1970 to 1972. The overall rate of growth of the economy was maintained, thereby, at a level in excess of 8 percent per annum throughout the period of crisis in 1974-75, rising further to 10 to 11 percent in 1976-77. While the share of the government in total gross capital formation rose from about one-sixth in 1973-74 to about one-fourth in 1975, the

government deficit was gradually reduced from 5.4 percent of GNP in 1972, before the crisis, to 2.2 percent in 1975, and the government sector was in balance in 1976-77. The government also took steps to moderate the expansion of credit. The growth rate of domestic credit, after reaching a level of 54 percent in 1974, declined to 32 percent in 1975, and a little over 20 percent in 1976-77. A more important deflationary factor, probably, was the much smaller increase in industrial real wages than in industrial productivity from 1970 to 1975. In 1976-77, however, real wages appear to have recovered some of the lost ground.

Developments in the Philippines were similar to those in Brazil and the Republic of Korea in the sense that the government sought to keep the growth of the economy going with the aid of large-scale inflows of capital. Investment, both public and private, was encouraged, particularly in food production and construction facilities for tourism. Credit policy accommodated the growth of the economy and domestic credit increased by 31 percent in 1974 alone - the highest rate of increase in 25 years. The inflation, nevertheless, slowed down in 1975 and 1976 and monetary and fiscal policy became strongly expansionist to compensate for the deflationary impact of the balance of payments deficit. The slowing down of inflation was due to a slackening in the upward trend of foreign trade prices, the marked increase in food supplies resulting in part from the previous investment, and the sharp drop in the real earnings of industrial workers and poor farmers. Industrial wage rates fell by almost 20 percent in real terms in 1974 alone, and the overall decline from 1972 to 1977 amounted to 30 percent for unskilled and 27 percent for skilled workers - an erosion of purchasing power without parallel in the country's postwar economic performance.

Jamaica and Tanzania were among those that resisted the application of general deflationary policies as a means of coping with balance of payments problems, but encountered severe limitations on their freedom of action in this respect because of inadequate access to balance of payments support. In Jamaica, the deflationary effect on demand of the deterioration in the balance of payments was compounded by the continuation of a downtrend in private investment. On the other hand, a tightening of import restrictions and exchange controls adversely affected the output of locally manufactured goods, thereby adding internally generated price pressures to the imported inflation. The government's first reaction was to reduce private consumption, especially of imported luxuries and consumer durables, through heavy sales taxes, while maintaining the government's expenditure program intact to support the level of employment. The government also levied additional taxes and royalties on bauxite and negotiated an increase in the export price of sugar with the United Kingdom.

Support for the balance of payments was also obtained from the IMF under the compensatory financing facility, and from other sources. The easing of the foreign exchange position led to a relaxation, in the second half of 1974, of the restrictive measures introduced earlier in the year. In 1975, various tax incentives were provided to stimulate production and employment, but the economy remained depressed, and incentives to higher savings were also unsuccessful as prices continued to rise. Since tax revenues were falling owing to the depressed state of the economy, tax rates were increased in 1976, but the budget deficit continued to rise. Over the period from 1974 to 1976 as a whole, there was substantial credit expansion, a liberal policy toward government borrowing more than offsetting restrictions on credit to other sectors. In 1975, guidelines for wages and profits were introduced on a voluntary and temporary basis, while the scope of price control was increased. Attempts to require Wage Tribunals to restrict their awards did not, however, succeed, and a wage freeze in the public sector was not maintained. Fiscal and monetary constraints were introduced in 1977 as part of a program of adjustment agreed upon with the Fund in the context of a standby arrangement. However, the agreed reduction in the budget deficit was not achieved since many programs could not be halted without severe disruption, and Jamaica, therefore, failed to satisfy the Fund's conditions for drawing in the second tranche. A subsequent arrangement for a drawing under the extended Fund facility, while retaining the nonexpansionary fiscal objective, made allowance for the need to make adequate provision for ongoing programs, and to give more time for adjustment. As noted earlier, a steep devaluation was also undertaken which, in conjunction with more effective restraint on money incomes, was intended to reduce consumption in real terms through "corrective inflation" and, thus, release resources for investment.

In Tanzania, the broad strategy approved in April 1974 provided for major increases in agricultural prices to encourage output and maintain rural consumption levels; minimum wage increases of 40 percent, with lower percentage increases at higher levels; sharp increases in basic food retail prices; credit budgeting to accommodate the new price structure; foreign exchange budgeting to provide minimum levels of basic foodstuffs, fuel and essential agricultural and industrial inputs and equipment; moderate curtailment of public investment; tax increases sufficient to sustain a moderate government surplus; and utmost mobilization of external finance. The Tanzanian government declined to accept a standard deflationary program, preferring to allow its entitlement to draw in the second IMF credit tranche, approved in August 1975, to lapse, rather than curtail public investment or inventory levels still further. The strategy was adhered

to, with some amendments, until 1977, by which time the situation had improved and it was possible to envisage the resumption of a more dynamic growth perspective.

In Peru, initial reaction to the upsurge in import prices in 1974 was conditioned by buoyant export prices, and by expectations that prospects were favorable not only for existing exports but also for exports of petroleum. These expectations, which seemed justified in terms of the information available at that time, and which were accepted as reasonable by the international agencies, prompted the government to maintain the rate of growth of the economy, and step up the rate of investment sharply. The heavy current account deficit in the balance of payments that resulted was financed by borrowing abroad on a scale that permitted significant additions to foreign exchange reserves. This policy was continued into 1975, by which time, however, the volume of exports was falling significantly and the price of copper declined, so that the current account deficit continued to increase rapidly and reserves dropped by a billion dollars despite further heavy borrowing. A further deterioration in exports and the current account balance in 1976 led to the negotiation of a \$400 million loan from a consortium of private banks, on the basis of a program that included the introduction of a "crawling peg" exchange rate, targets for cutting government expenditure and restraining credit to the public and private sectors, and increases in controlled prices, including a doubling of the price of gasoline. It was the government's impression that these terms were more favorable than would have been possible for a drawing on the Fund. The government did not, however, make the cuts in expenditure required, and in February 1977 the banks insisted that the drawing of the second half of the loan previously made would be conditional on agreement between the government and the Fund on the further steps to be taken. This did not prove possible owing to disagreement with the Fund on the degree of further deflation to be undertaken, and a wave of public protest against further increases in the prices of food and fuel. In October 1977 agreement was finally reached with the IMF whereby the government's current deficit, equivalent to 3.6 percent of GDP in 1977, was to be replaced by a surplus of 2 percent in 1978 - a provision which turned out to be unrealistic within the time frame envisaged. In July 1978, a new standby arrangement was negotiated with the Fund, whereby the government was to achieve a surplus in its current account of approximately 5.8 percent of GDP in 1979 and 1980. Public investment was to be maintained as a proportion of GDP while current government expenditure was reduced. A tax reform would be introduced. These measures were to be accompanied by adjustment of the exchange rate to a level that would permit a recovery of reserves, and

controlled prices were to be allowed to rise to a level sufficient to cover costs for both public and private enterprise. Most of the available bank credit would be channeled to the public sector in 1978, while credit to the private sector would fall in real terms. In 1979 and 1980, the expected reductions in public sector deficits were to permit expansion of credit to the private sector. Positive real rates of interest were to be introduced. It was foreseen that even these measures, which themselves assumed some recovery in export prices in 1979-1980, would leave a substantial external financing gap in 1978, and, even larger, though gradually falling, gaps in 1979 and 1980. In late 1978, the Peruvian authorities reached agreement with foreign creditors on the refinancing of its debt, which will reduce the service payments due in 1979 and 1980. While valuable time has been gained thereby, debt service will remain high in relation to exports over the next several years. Moreover, the short duration of the relief obtained imposes great burdens on economic management and forward planning.

In the case of India, policy was primarily addressed to the control of inflation rather than to balance of payments considerations. By the middle of 1973, domestic prices were rising at a rate of 2 percent per month. Fiscal policy, therefore, sought to reduce government expenditure sharply and levy substantial additional tax revenue. The upward movement of prices accelerated, nevertheless, increasing by as much as 18 percent in the six months ending July 1974. The government, therefore, introduced still further extraordinary measures in a supplementary budget presented in July 1974, including a novel tax of seven percent on the gross interest earned by banks. This was withdrawn at a later stage when inflation subsided. Compulsory deposits at the Reserve Bank of India were required of increases in wages and salaries, to be repaid at interest in five annual installments. The distribution of after-tax profits was sharply curtailed. And income tax payers with incomes over 15,000 rupees were required to deposit with banks between 4 and 10 percent of their incomes. Steps were also taken in 1973-74 and 1975 to raise the cost of credit, the minimum reserve ratios of the banks, and margin requirements for financing holdings of commodities. A minimum lending rate of 10 percent on bank advances was introduced in 1973-74, which was raised to 12.5 percent in 1974-75. The lending rate on commodity stocks reached 15 percent in 1974-75. Monetary expansion in 1974-75 was reduced to less than half the rate of the previous year. Net bank credit to the government was reduced by 23 percent in 1974-75 and net credit to the private sector by 20 percent. However, the export sector was favored regarding both access to and the cost of credit. Prices began to decline in September 1974, only two months after the situation had been deemed critical enough to require a supplementary budget and

additional drastic measures. There certainly had not been sufficient time for reductions in the flow of income and expenditure to take effect. Presumably, one of the key factors in the first stage of the price decline was a liquidation of commodity inventories under the pressure of the rise in margins and in the cost of credit. More fundamental factors were favorable harvests, major increases in the volume of food imports every year from 1973-74 to 1975-76, and a large measure of "corrective inflation" coupled with strong steps to hold down wage advances. By 1976-77 there was a complete reversal of the balance of payments position in India, a small trade surplus being recorded as well as a sharp increase in the level of reserves. There was practically no further rise in the general level of prices and consumer prices actually dropped by 5 percent from 1974-75 to 1976-77, as noted earlier.

Particular interest attaches to the policy approach adopted by the government of Kenya because it reflected an effort, as in Tanzania, to relate the problems of short-term economic management explicitly to longer-run goals but, in the case of Kenya, with international support. The new policy was worked out in the context of an application for a program loan of \$30 million from the World Bank and for a drawing on the Extended Fund Facility (EFF). The program loan - in support of plans containing some of the elements included in Kenya's EFF program - was intended to finance imports of essential raw materials, capital and intermediate goods to help Kenya to adjust to the deterioration in its balance of payments and to maintain a reasonable rate of development while long-term changes were made in its structure of growth.(7) Among the specific measures required as conditions for the program loan were the following:

1. to reduce domestic inflation through an incomes policy and especially wage restraint;
2. to make the tariff structure more uniform;
3. to encourage agricultural production through greater public investment and higher prices for agricultural commodities;
4. to restructure the manufacturing sector to make it more domestic-resource based and more export oriented; and
5. to restructure the government budget in the following ways:
 - (a) devote more budgetary resources to agriculture, water, and rural access roads;
 - (b) establish a better relationship between the current and development budgets;

- (c) hold down expenditure on nondirectly productive activities; and
- (d) among the social services, to put more emphasis on expenditures affecting rural communities, especially the rural poor, as well as on investments to meet the needs of the urban poor.

The Fund and the World Bank were in agreement on the above conditions, but the Fund also required a detailed statement of policies and measures for the first 12 months, including credit ceilings for bank lending to the private sector and to the government. The Fund was to review progress every six months and the government was to present further statements on policies and measures for the two succeeding 12-month periods. Accordingly, the government published a major policy document setting forth its medium-term development strategy, and substantially incorporating the foregoing conditions(8). Real GDP was to increase at an average annual rate of at least 5 percent from 1975 to 1978, while the growth in private consumption was to be held down to the rate of growth in population (3.5 percent) and the growth rate of public consumption was to be reduced by a third. The latter would generate a current account budgetary surplus that would finance at least a third of the increasing development expenditure. The restructuring of investment and control on demand were expected to release resources for exports. The broad approach set forth above is suggestive of the possibilities for bringing together the requirements of short-term and long-term economic management within a consistent framework. The complex institutional procedures, involving two major international agencies, may have required a great deal from the limited technical resources of the government of a developing country, but the efforts of the Fund and Bank to achieve a concerted approach were certainly helpful. Unfortunately it proved impossible for the government and the Fund to reach agreement on the 1976 government budget for the second year of the EFF, and since, in the meantime, the balance of payments situation had greatly improved as a result of the rise in the prices of coffee and tea, Kenya decided to make no further drawings on the facility.

The case of Uruguay is also instructive. That country had already adopted policies in accord with Fund principles nine months before the standby arrangement in the first credit tranche of May 1975, and in any case, no conditions were proposed by the Fund that the government had not itself decided to apply. Interest rates were substantially increased, thereby making it possible for the government, beginning in 1974, to finance part of its deficit through the sale of bonds and Treasury bills denominated in foreign currency. Although

central bank credit to the government continued to increase in real terms, its share of the total borrowing requirements of the government was reduced from 57 percent in 1973 to 26 percent in 1975. In 1976-77, however, the importance of central bank credit to the government increased sharply once again. Meanwhile, credit to the private sector was progressively liberalized, virtually doubling in real terms from December 1974 to September 1977, with the objective of facilitating the growth of production and exports. Thus, the slowing down in the rate of increase of consumer prices from nearly 80 percent in 1973-74 to under 50 percent from mid-1977 to mid-1978 must be attributed to factors other than credit policy. The most important of these was the policy of "corrective inflation" that allowed prices of foodstuffs, urban rents, and other consumer goods and services to increase, thereby reducing real wages. From 1971 to the second half of 1977, real wages fell by 40 percent, of which 30 percent occurred from the beginning of 1974.

In Zambia, the difficulties resulting from soaring import prices and, subsequently, from the collapse of copper export prices were greatly compounded by serious economic dislocation resulting from participation in the United Nations program of sanctions against Rhodesia. Macroeconomic policies were modified in response to the crisis, but only with some delay owing to the relatively favorable export performance in 1974. In fact, an increase in government expenditure was proposed in January 1975 to offset the slackening of activity that had begun in 1974, and since expenditure exceeded budget estimates while revenues fell short as a result of copper price declines, the budget deficit increased considerably. The government was only moderately successful in seeking to reduce government expenditure from 1976 to 1978, and continued declines in mineral revenues offset increases in nonmineral revenues. Meanwhile, credit policy accommodated requirements arising not only from the government but also from the mining companies and state enterprises, from the general advance in prices, and from the need for bridging finance for importers because of long delays in delivery of imports resulting from the Angolan war and port congestion. In January, 1976, a number of measures of credit restraint were adopted in connection with the negotiation of a standby program with the IMF, but the effect of these was offset by continuing budget deficits. Nor did a 20 percent devaluation in July 1976 bring significant benefits. By the beginning of 1978, the situation had deteriorated to the point where a massive program of external bilateral and multilateral assistance was combined with a further devaluation of 10 percent, as well as severe measures of retrenchment, especially of government expenditure, in an effort to restore internal and external balance.

In Sri Lanka, the problem of adjustment was superimposed on a situation in which developmental imports had already been greatly compressed owing to limited foreign exchange availabilities and the need for substantial imports of food. Given the importance in the government's budget of food subsidies and of subsidies to state enterprises, the increases in the prices of imports after 1973 had to be passed on to consumers to a considerable degree if the budget deficit, and the public sector's call on credit and savings, was to be contained. Before the end of 1973, the government introduced an economic package which included selective price increases in line with import price increases. Prices of petroleum products were raised, and, given the rigidity of the import structure, the amount of food distributed on ration at subsidized prices was reduced. Owing to the further deterioration in the terms of trade that ensued, these measures proved inadequate, so that in 1974 further adjustment in the food distribution program and price increases had to be implemented, despite an improvement in the domestic harvest. In recognition of the need to move toward agricultural self-sufficiency to mitigate the pressure on developmental imports, the fertilizer subsidy was retained, and the producer price for rice was increased in 1974. External finance played a major and increasingly important role both over the period from 1974 to 1976 and subsequently. The main component was official aid, which doubled in monetary terms compared with the early 1970s, with a substantial increase in the share of grants, and an easing of the terms on long-term loans. The total purchasing power of concessional finance declined, nevertheless. IMF finance was small in comparison, and consisted mainly of drawings on low-conditionality facilities. A standby in 1974 lapsed after the first drawing since the ceiling on net domestic credit had been exceeded. The IMF did not become a major source of finance until the conclusion of the 1977 standby and the introduction of a completely new economic strategy based on an opening up of the economy to market forces. Important elements of the new approach were unification and devaluation of the exchange rate, liberalization of imports, and reduction of the subsidized rice ration.

The problem of adjustment in Indonesia, while similar to that arising in a number of other countries in the sense that it involved dealing with excess pressure of demand on resources accompanied by rising price pressures, both imported and domestic, was quite different in origin. It was the result, at first, of a boom in public and private development expenditure that owed much to the stimulus of an upsurge in the value of exports, particularly of petroleum. To this the government's response was orthodox. Government budgets were held in balance and credit was curtailed. Moreover, despite pressures on the balance of payments, the flow of imports, financed

partly by a rapidly increasing influx of capital, was sufficient to meet requirements, including the heavy food needs occasioned by the poor harvest of 1972-73. The balancing of the budget was, however, an insufficiently restrictive measure because production capacity was not adequate to supply the expansion in government investment demand. Moreover, the restraints on credit had little effect on the large enterprises that were able to borrow from abroad at cheaper interest rates. The pressures on internal and external balance would probably have been manageable with the aid of some further restraint had it not been for the added complication of a liquidity crisis in 1975 that resulted from the persistent financing of capital development projects out of foreign short-term borrowing by the public enterprise Pertamina. A large proportion of Pertamina's loans fell due in 1975, at a time of decline in non-oil-export earnings, and a lesser increase in oil exports than expected. This not only caused difficulties in the repayment of foreign debt but also led to inflationary financing of government investment projects because of the shortfall in oil resources. Public sector recourse to bank credit in 1975 reached an unprecedentedly high level equivalent to about nine percent of GNP. The government took over responsibility for Pertamina's debts and managed to renegotiate or refinance most of the obligations falling due, though some contracts had to be cancelled despite the heavy penalties thereby incurred. The basic strength of Indonesia's position was reflected in the speed with which the crisis was overcome, and in the fact that the balance of payments deficits of 1974-75 and 1975-76 were replaced by a very large surplus in 1976-77 and a resumption of capital inflows.

CONCLUSION

The experience of the 13 countries from 1974 to 1976 was conditioned by two fundamental and highly interrelated factors: their capacity to adjust by expanding export earnings, and their ability to attract and mobilize external resources in support of the development process. In addition, "chance factors," such as the pattern of behavior of commodity prices, played an important role.

Some countries (Brazil, Ivory Coast, Republic of Korea, Philippines) had experienced a fairly rapid expansion of their total import capacity during 1972-73. These countries had also established access to private capital markets, and drew heavily on this source of finance after 1973. Two of these countries succeeded in maintaining or re-establishing rapid growth in export earnings, so that their earned import capacity continued to advance. In the case of the Ivory Coast, this

was primarily the result of offsetting swings in commodity prices that kept the unit values of Ivory Coast commodity exports moving upward throughout the period, together with expansion in the production of agricultural exports. In the case of the Republic of Korea, it reflected continued vigorous export promotion, together with a redirection at the margin of export supply toward rapidly growing markets. Under these circumstances, the role in maintaining import capacity that had to be played by external finance, including payments finance and use of reserves, was relatively modest. With import capacity moving upward, the domestic economy adjusted relatively easily to the new situation, and the growth of investment, manufacturing output, and GDP continued to be vigorous. In Brazil and the Philippines, the rapid increase in earned import capacity that had occurred prior to 1974 could not be sustained from 1974 to 1976 and a greater burden consequently fell on external financing. In the Philippines, external borrowing rose sharply, and the adjustment process was accompanied by an expansion of import availabilities and by continued vigorous growth of manufacturing output, investment, and GDP. In Brazil, although there was a considerable expansion of borrowing and a determined effort to compress nonessential imports, difficulties were encountered in reconciling rapid growth with available import capacity, and a slowdown in GDP growth occurred in 1974 and 1975.

All four of the above countries had a moderate or high capacity to adjust, although in the case of the Ivory Coast, in addition to the expansion of the volume of exports, the pattern of change of commodity prices was particularly fortunate. In Brazil and the Republic of Korea, this capacity was rooted in the rapid economic growth which had characterized their economies in the preceding period. This growth, in turn, was a prime factor allowing access to international capital markets. Thus, a high capacity to adjust was accompanied by a relatively high capacity to finance deficits, and these two factors came together in a way that limited disruption of the growth process.

Two other countries, India and Uruguay, also had a relatively high capacity to adjust, and reacted strongly to pressure on the balance of payments by expanding and diversifying exports. In India, a period of compression of developmental imports was nonetheless unavoidable. In both countries there was a large measure of "corrective inflation" whereby prices of consumer goods increased while wage advances were restrained. In India this contributed to a remarkable halt to inflation.

The remaining countries in the group had moderate or low capacities to adjust, and entered the period 1974 to 1976 with earned import capacities below the levels they had achieved in 1970. Long-term capital flows had played a role in expanding

import capacity in Peru and Tanzania, but had not been a source of growth in foreign exchange availabilities in the other countries. Long-term lending also played little role in supporting import capacity after 1973, except in Peru. Reserve availabilities and payments finance were also inadequate and, at best, cushioned declines in import capacity during the first year in which they occurred. The declines in earned import capacity that occurred, thus, were passed through to the economy in the form of a reduction in imports of such magnitude that compression of developmental imports was unavoidable.

The consequences of these events were quite detrimental to growth and development. Those sectors most sensitive to foreign exchange availabilities, in particular manufacturing, experienced a decided deceleration in rates of growth of output. Real wages fell in a number of countries, sometimes by substantial amounts. Moreover, investment declined noticeably in all these countries, and a number of them experienced one or more years of net disinvestment. The inability to provide to the domestic economy minimal protection from external disturbances thus stunted the growth of productive capacity, or even reduced that capacity.

Table 2.14. Selected Indicators: Brazil

	GDP at		Current account	Change in reserves		Ratio of
	constant prices (1970 = 100)	GDP deflator (1970 = 100)	balance (millions of dollars)	Basic balance (millions of dollars)	and related items ^{a/} (millions of dollars)	reserves to imports (per cent)
1970	100.0	100.0	- 569	- 578	- 574	42
1971	113.3	117.3	-1319	- 642	- 536	47
1972	126.6	137.7	-1494	26	-2427	87
1973	144.2	165.9	-1763	851	-2313	92
1974	158.3	218.2	-7179	-2852	962	37
1975	167.3	289.6	-6739	-2307	1010	30
1976	182.7	409.2	-6207	-2044	-2266	48
1977	191.3	583.9	-4854	1032	- 699	55
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	13.0	18.4	-1525	78	-1759	75
1974-76	8.2	35.2	-6708	-2401	-98	38

Source: Country study; IMF, International Financial Statistics (various issues); IMF Balance of Payments Yearbook; Supplement to Volume 28 (December 1977).

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.15. Selected Indicators: India

	GDP at		Current account		Change in reserves		Ratio of reserves to imports (per cent)
	constant prices ^{a/} (1970 = 100)	GDP deflator ^{a/} (1970 = 100)	balance (millions of dollars)	Basic balance (millions of dollars)	and related items ^{b/} (millions of dollars)	(per cent)	
1970	100.0	100.0	- 462	192	- 311	42	
1971	101.5	104.3	- 717	46	- 123	50	
1972	100.4	114.6	- 227	170	21	53	
1973	105.6	135.5	- 567	- 65	108	36	
1974	106.1	160.4	- 819	247	20	26	
1975	115.1	176.0	- 222	780	- 356	22	
1976	117.0	176.2				54	
1977						81	
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)	
1971-73	1.9	10.8	- 469	136	- 138	46	
1974-76	3.6	9.5	- 536	321	- 76	34	

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook; Supplement to Volume 28.

^{a/} Fiscal year beginning April 1 of the calendar year indicated.

^{b/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.16. Selected Indicators: Indonesia

	GDP at constant prices (1970 = 100)	GDP deflator (1970 = 100)	Current account		Change in reserves and related items ^{a/} (millions of dollars)	Ratio of reserves to imports (per cent)
			balance (millions of dollars)	Basic balance (millions of dollars)		
1970	100.0	100.0	- 376	- 20	- 12	16
1971	106.2	107.5	- 418	5	1	17
1972	115.1	129.3	- 385	166	- 407	37
1973	128.1	169.7	- 530	45	- 340	30
1974	137.3	237.0	548	1089	- 688	39
1975	144.8	265.0	-1135	1136	857	12
1976	155.1	301.8	- 922	1355	- 922	26
1977			- 39	1476	- 997	40
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	8.6	19.7	- 444	72	- 249	28
1974-76	6.6	21.8	- 503	1193	- 251	26

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.17. Selected Indicators: Ivory Coast

	GDP at		Current account		Change in reserves		Ratio of
	constant prices (1970 = 100)	GDP deflator (1970 = 100)	balance (millions of dollars)	Basic balance (millions of dollars)	and related items ^{a/} (millions of dollars)	reserves to imports (per cent)	
1970	100.0	100.0	- 69	29	- 39	31	
1971	107.0	99.4	- 137	- 8	- 15	22	
1972	114.0	100.1	- 151	- 70	66	19	
1973	120.6	113.4	- 267	3	6	12	
1974	123.9	144.9	- 102	112	- 61	7	
1975	132.6	151.7	- 420	- 116	84	9	
1976	149.1	176.9	- 238	41	- 30	6	
1977	160.7		- 431	156	- 110	11	
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)	
1971-73	6.4	4.5	- 185	- 27	29	18	
1974-76	7.4	16.4	- 253	12	- 2	7	

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.18. Selected Indicators: Jamaica

	GDP at		GDP deflator (1970 = 100)	Current account		Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)		Ratio of reserves to imports (per cent)
	constant prices (1970 = 100)	(average annual rate of change)		balance (millions of dollars)	(annual average)				
1970	100.0		100.0	- 150		6	- 21		27
1971	101.6		107.4	- 166		18	- 26		32
1972	109.3		111.4	- 190		- 71	25		26
1973	106.2		137.5	- 241		- 42	30		19
1974	104.3		180.5	- 83		134	- 70		20
1975	103.2		215.3	- 288		- 78	74		11
1976	96.1		240.5	- 307		- 215	261		4
1977				37		- 21	4		6
		(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	2.1		11.5	- 199		- 32	- 10		26
1974-76	-3.3		20.8	- 226		- 53	88		12

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.19. Selected Indicators: Kenya

	GDP at constant prices $\frac{(1970 = 100)}{}$	GDP deflator $\frac{(1970 = 100)}{}$	Current account		Basic balance $\frac{(\text{millions of dollars})}{}$	Change in reserves and related items ^{a/} $\frac{(\text{millions of dollars})}{}$		Ratio of reserves to imports $\frac{(\text{per cent})}{}$
			balance $\frac{(\text{millions of dollars})}{}$					
1970	100.0	100.0	- 76		31	- 51		50
1971	106.4	104.2	- 174		- 69	- 65		30
1972	111.8	111.2	- 97		17	- 29		38
1973	119.7	119.9	- 153		3	- 21		38
1974	125.6	140.3	- 340		- 119	88		19
1975	126.3	160.1	- 251		- 76	49		18
1976	134.0	185.9	- 124		67	- 85		28
1977			- 30		250	- 279		41
	(average annual rate of change)	(average annual rate of change)	(annual average)		(annual average)	(annual average)		(annual average)
1971-73	6.2	6.2	- 141		- 16	5		35
1974-76	3.9	15.8	- 238		- 43	17		22

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook; Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.20. Selected Indicators: Republic of Korea

	GDP at constant prices <u>(1970 = 100)</u>	GDP deflator <u>(1970 = 100)</u>	Current account balance <u>(millions of dollars)</u>	Basic balance <u>(millions of dollars)</u>	Change in reserves and related items ^{a/} <u>(millions of dollars)</u>	Ratio of reserves to imports <u>(per cent)</u>
1970	100.0	100.0	- 706	- 163	- 57	31
1971	109.2	111.5	- 912	- 320	42	24
1972	116.5	127.7	- 420	125	- 169	29
1973	135.2	139.7	- 343	349	- 349	26
1974	145.8	177.1	-2095	- 949	172	15
1975	158.3	220.8	-1926	- 295	- 376	21
1976	181.0	255.1	- 466	1200	-1316	34
1977	198.5		- 40	1300	-1370	40
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	10.7	11.8	- 558	51	- 159	26
1974-76	10.2	22.3	-1496	- 15	- 507	23

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook; Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.21. Selected Indicators: Peru

	GDP at constant prices (1970 = 100)	GDP deflator (1970 = 100)	Current account balance (millions of dollars)	Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)	Ratio of reserves to imports (per cent)
1970	100.0	100.0	146	185	- 299	55
1971	105.3	104.6	- 69	-25	35	57
1972	111.6	110.8	- 64	75	- 23	61
1973	117.9	125.1	- 299	147	- 94	56
1974	126.3	144.3	- 752	6	- 399	63
1975	130.5	179.5	-1574	- 248	497	18
1976	134.7	246.7	-1231	- 347	369	17
1977-	132.6		- 967	18	2	22
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	5.7	7.8	- 144	66	- 25	58
1974-76	4.5	25.7	-1186	- 200	156	33

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook; Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.22. Selected Indicators: Philippines

	GDP at constant prices (1970 = 100)	GDP deflator (1970 = 100)	Current account		Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)		Ratio of reserves to imports (per cent)
			balance (millions of dollars)	(annual average)				
1970	100.0	100.0	- 74		82	- 83		21
1971	105.8	112.5	- 33		- 11	- 125		29
1972	110.8	120.2	- 29		122	- 202		39
1973	120.4	141.5	412		607	- 668		58
1974	126.7	186.5	- 283		20	- 590		43
1975	135.1	201.5	- 990		- 406	-		36
1976	145.1	218.0	-1133		37	58		42
1977	153.6		- 849		99	26		36
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)	(annual average)	
1971-73	6.4	12.3	117		239	- 332		42
1974-76	6.4	16.0	- 802		- 116	- 179		40

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.23. Selected Indicators: Sri Lanka

	GDP at constant prices (1970 = 100)	GDP deflator (1970 = 100)	Current account balance (millions of dollars)	Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)	Ratio of reserves to imports (per cent)
1970	100.0	100.0	- 71	- 27	- 17	11
1971	100.2	101.5	- 54	31	- 10	14
1972	103.4	105.3	- 49	16	- 30	16
1973	107.1	122.0	- 38	26	- 29	20
1974	110.1	153.8	- 178	- 63	11	11
1975	114.0	165.4	- 187	- 21	25	8
1976	117.5	176.4	- 66	76	- 57	16
1977		194.1			- 210	42
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	2.3	7.0	- 47	24	- 23	17
1974-76	3.1	13.4	- 144	- 3	- 5	12

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.24. Selected Indicators: United Republic of Tanzania

	GDP at		GDP deflator (1970 = 100)	Current account		Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)		Ratio of reserves to imports (per cent)
	constant prices (1970 = 100)			balance (millions of dollars)					
1970	100.0		100.0	- 38		35	15		20
1971	104.2		103.5	- 102		38	9		16
1972	110.4		110.0	- 77		42	- 55		30
1973	114.6		122.1	- 126		50	- 32		29
1974	117.5		145.1	- 328		- 142	137		7
1975	122.8		167.1	- 318		- 65	16		8
1976	129.2		187.2	- 79		50	- 22		18
1977	136.4		208.7	- 108		102	- 161		39
	(average annual rate of change)		(average annual rate of change)	(annual average)		(annual average)	(annual average)		(annual average)
1971-73	4.7		6.9	- 102		43	- 26		25
1974-76	4.1		15.3	- 242		- 52	44		11

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.25. Selected Indicators: Uruguay

	GDP at constant prices (1970 = 100)	GDP deflator (1970 = 100)	Current account		Basic balance (millions of dollars)	Change in reserves and related items ^{a/} (millions of dollars)		Ratio of reserves to imports (per cent)
			balance (millions of dollars)					
1970	100.0	100.0	- 55		- 34	18		76
1971	99.0	121.4	- 71		- 11	5		79
1972	95.5	211.6	46		78	8		96
1973	96.3	429.3	17		50	- 37		84
1974	99.3	743.2	- 155		- 106	52		48
1975	103.7	1305.0	- 216		- 78	50		39
1976	106.4	1966.7	- 83		- 12	- 77		54
1977	110.1	2955.9	- 150		- 96	- 178		63
	(average annual rate of change)	(average annual rate of change)	(annual average)		(annual average)	(annual average)		(annual average)
1971-73	- 1.2	66.2	- 3		39	- 8		86
1974-76	3.4	66.5	- 151		- 65	8		47

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

Table 2.26. Selected Indicators: Zambia

	GDP at	GDP deflator	Current account	Change in reserves		Ratio of
	constant prices (1970 = 100)	(1970 = 100)	balance (millions of dollars)	Basic balance (millions of dollars)	and related items ^{a/} (millions of dollars)	reserves to imports (per cent)
1970	100.0	100.0	107	- 17	- 145	92
1971	99.7	94.5	- 249	- 265	253	44
1972	107.1	97.5	- 211	109	141	25
1973	109.3	115.7	126	140	12	29
1974	118.4	129.1	70	130	- 10	18
1975	118.1	106.2	- 617	- 479	79	13
1976	120.6	119.1	- 63	- 14	- 72	12
1977	115.8		- 226	- 192	39	9
	(average annual rate of change)	(average annual rate of change)	(annual average)	(annual average)	(annual average)	(annual average)
1971-73	3.1	5.5	- 111	- 5	135	33
1974-76	3.4	2.0	- 203	- 121	47	14

Source: Country study; IMF, International Financial Statistics; IMF, Balance of Payments Yearbook: Supplement to Volume 28.

^{a/} Minus sign indicates increase in reserve assets or decrease in reserve liabilities.

3

Evaluation of Issues

INTRODUCTION

The present study is concerned primarily with the international environment in which individual countries adjust their balances of payments. A satisfactory international environment would facilitate national adjustment and avoid placing obstacles in its way. It would, thereby, help countries in making the shifts in production and trade required for more effective deployment of their resources without incurring unnecessary losses of employment or income. The international community cannot itself take the steps needed to expand and diversify export capacity in the developing countries. But it can, by concerted action, maintain the highest possible level and rate of growth of import demand so that countries that create an efficient capacity to export will be able to find market outlets. In general, the greater the contribution of higher exports to the narrowing of trade deficits the smaller will be the burden on the deficit countries of reducing imports and, hence, domestic production and income. The international community can also take steps to stabilize the prices of primary commodities at remunerative levels. In addition to other benefits of such action, one of the principal sources of balance of payments difficulties in developing countries would, thereby, be mitigated.

In the developing countries themselves, the adjustment process tends to be easier if it takes place in the context of as high a level of business activity as possible. This, in turn, necessitates the utmost mobilization of domestic resources, and the most efficient use and allocation of these resources. But it also calls for the greatest possible flow of long-term capital from developed to developing countries, on the terms and

conditions appropriate to the respective levels of development and per capita income of the latter countries.

Chapters 1 and 2 have drawn attention to the distinctive features of the adjustment process during the 1970s, particularly as it affected developing countries. Among the salient points made are the following:

1. The international environment was unfavorable in the sense that adjustment confronted unusually severe difficulties in the climate of recession followed by stagflation that prevailed from 1974 onward.
2. The primary factors in balance of payments deficits were not, as in the past, associated with excessive pressure of domestic demand. While elements of demand pressure were still to be found, the more characteristic experience was cost inflation - resulting, at least in part, from soaring import prices - accompanied by real demand deflation. Balance of payments deficits were not generally due to substantially expanded import volumes but rather to increases in the general level of prices and deterioration in the terms of trade - circumstances for which the developing countries in deficit were not responsible.
3. The capacity of developing countries to adjust to the pressures on their balances of payments varied greatly. Generally speaking, the countries that were best able to cope with the situation were those that had already succeeded in attaining a certain degree of diversification of their economies (notably through the establishment of manufacturing activities with an export potential) and that were able to borrow in private capital markets. These countries managed to sustain, and in some cases even increase, the level of activity and the momentum of the development process. It was the poorer countries, on the whole, that suffered most from the pressures upon them. The assistance afforded to the latter countries by the international community was far from sufficient to offset the disadvantages inherent in the rigidity of their economies and their limited access to other borrowing facilities.
4. Thus, the overall impact of the international environment was perverse, and a disproportionate share of the burden of adjustment

was shouldered by the developing countries in general, and by the poorest among them in particular. In many cases, the adjustment process involved severe disruption of development programs and, in some at least, unprecedented declines in real incomes.

It remains to examine some of the main issues that arose in the course of the adjustment process, at both national and international levels. For this purpose it may be convenient to organize the discussion under the following headings: origins of an international approach to the adjustment process; the asymmetry of adjustment; framework and objectives; problems of diagnosis and financial programming; targets and instruments; conditionality and the use of resources; trade policies; policies on exchange rates; and the rate of adjustment and the adequacy of resources.

ORIGINS OF AN INTERNATIONAL APPROACH TO THE ADJUSTMENT PROCESS

It is useful to consider how the need for deliberate policies for adjustment of the balance of payments arose, and what objectives such policies should serve. For it is not self-evident that a particular country invariably makes the best contribution in its own interest or in the interest of the world economy by a speedy elimination of its current account deficit. Indeed, it is not evident that the aims of balance of payments policies or of the adjustment process are best expressed in terms of objectives relating to the current account of the balance of payments.

The whole range of problems that are now summed up under the heading of "adjustment process" is relatively new. Under the gold standard before World War I, the adjustment of the trade and payments balances of individual countries proceeded automatically along lines that will be described briefly in the course of subsequent discussion. Though there is room for argument as to how balance of payments equilibrium was maintained and what form this automatic adjustment process took, it is evident that the process was not directed or guided by any person or institution in any conscious manner. Indeed most people had no clear view as to the manner of its operation. Nor could it be said that this automatic system was optimal from the point of view of the welfare of the individual country or of the world community as a whole. The system did not prevent large instabilities in the prices of exports and imports and consequent haphazard shifts in the distribution of income among countries. The very fact

that it operated so forcefully and so quickly may have been the cause of an unnecessary amount of hardship to workers in particular communities - whether they were primary producers or urban workers engaged in manufacturing. However that may be, the restoration of the gold standard after World War I did not recreate the success of the pre-World War I gold standard in generating compensating financial flows easily and quickly, thereby avoiding major financial crises. The system broke down shortly after the onset of the Great Depression in 1929.

The abandonment of the old system prompted the various countries to adopt a wide range of policies for dealing with their balance of payments problems. Governments began to take the view that the maintenance of a reasonable degree of economic stability in peacetime may require extensive regulation of international trade and payments. This led to the introduction of a whole host of instruments - import controls, controls on capital movements and on access to foreign exchange, multiple currency practices, and so forth - that were completely unknown to previous generations. It was during the 1930s that restrictions on international trade and payments were adopted by individual countries with the deliberate aim of increasing domestic output and employment levels. And it was then that it began to be understood that countries could not be left to take whatever steps each of them considered best in its own national interests, since such actions were often mutually inconsistent and, therefore, negated the advantages that each country might have secured if it had acted in cooperation and not in competition with others.

These considerations led, during and after World War II, to the general recognition of a need for an international code of behavior to ensure that the policies followed by various countries were consistent with one another and that individual countries followed good neighborly policies serving to promote and not to undermine the prosperity of others. The Bretton Woods Conference which led to the creation of the IMF and the World Bank may be regarded as the first systematic attempt at establishing such a code of behavior. As originally planned, the Articles of Agreement of the Fund and the Bank, which laid down rules of conduct in the field of policies concerning international payments and international assistance for reconstruction and development, were to be supplemented by a body of rules concerning international trade. However, the plan for rules of conduct that would ensure that trade and payments policies were coordinated to form a single comprehensive system was never realized. While the Bretton Woods agreements initiated a long period of postwar recovery and generally upward movement in the world economy, they did not prevent the economic development of particular

countries from being hampered by external constraints that sometimes had their origin in a conflict of national policies. The trading system did not yield a satisfactory equilibrium in trade and payments; some countries registered persistent surpluses and others chronic deficits, with which the system was not designed to cope. In the end, the system broke down as a result of a series of events leading to the abandonment of gold convertibility by the United States in August 1971. But the collapse of the Bretton Woods system cannot be said to have resulted in any easing of the external strains to which individual countries are subject. Indeed, the payments imbalances and the pressures to which they gave rise were even greater in the 1970s than in the two previous decades. This, in turn, served to emphasize the need for a new set of rules for international trade and payments that would pay due regard both to the interests of individual countries that are called upon to make adjustments in their economies and to the interests of their trading partners who might be affected by those adjustments. Sooner or later it will be necessary to seek intergovernmental agreement on such a set of rules. Pending such agreement, however, it is important, as a minimum, that the international community's long-term goals be kept clearly in mind in dealing with the adjustment process in developing countries.

The present study will not consider in any detail what the ultimate objectives of the adjustment policies of individual countries should be. There has been an increasing tendency to identify equilibrium in the current account as the proper goal of such policies. This, however, does not take account of the fact that most developing countries should, under normal conditions, be the net recipients of long-term capital flows - partly because they provide investment opportunities that are potentially superior to those that can be obtained elsewhere, and partly because it is the declared policy of the developed countries as well as of other capital-exporting countries to assist the growth of the developing countries through the provision of capital - whether in the form of concessional loans or grants by individual governments, long- or short-term loans by international financial institutions, or loans or investments made by the private exporters of capital. Ideally, it would be desirable if each country that is a net importer of capital could reach agreement with the capital-exporting countries on a long-term target for its basic balance of payments, that is, a long-term target for the excess of imports over exports that each country should expect to be able to maintain as the counterpart of the grants and loans that it receives.

Seen in these terms, the adjustment process should aim primarily at elimination of imbalances in trade that are not consistent with such long-term capital flows for development

purposes. In choosing policies that a country might be asked to adopt in pursuit of this objective, and in determining the rate at which it could reasonably be asked to eliminate an imbalance, attention should be paid to the question of whether the imbalance is the result mainly of the domestic policies of the deficit country or whether it is a reflection of untoward policies of some other country calling for a different type and rate of adjustment.

The International Monetary Fund has the primary responsibility for representing the international community in its relations with individual countries faced with balance of payments problems. It is, therefore, natural that consideration of the problems arising in the balance of payments adjustment process should focus particularly on relations between the Fund and its member countries. But it will be obvious from the foregoing discussion that the context in which the adjustment process takes place is far wider than the operations of the Fund, involving responsibilities going well beyond those of the Fund itself. The Fund must take many of the international parameters as given. It may make recommendations about them, but effective action lies elsewhere. One of the most important of these parameters is the international configuration of surpluses and deficits.

THE ASYMMETRY OF ADJUSTMENT

As is well known, the incentive to countries that are in persistent surplus on their balances of payments to adjust is relatively weak, mainly because the accumulation of foreign exchange reserves by these countries can continue almost indefinitely whereas the depletion of reserves by deficit countries must be brought to an end sooner or later. A fairly drastic remedy for persistent surpluses is provided in the Articles of Agreement of the International Monetary Fund in the form of the "scarce currency" clause - which remains in force notwithstanding the many other amendments to the Articles that have been adopted over the years. However, this remedy has never been invoked, no doubt mainly because it is drastic, involving discriminatory exchange and import restrictions against any "scarce currency" countries.⁽¹⁾ This being the case, Fund influence over the economic policies of member countries is heavily concentrated upon the deficit countries. It has, of course, been recognized that current surpluses and deficits may, depending on circumstances, be as much a reflection of economic conditions in, or policies pursued by, other countries as of conditions or policies in the surplus or deficit countries concerned. Thus, for example, a surplus may be due, in whole or in part, to the fact that import demand in

a particular country is limited in relation to its capacity to capture export markets. In that case, the inability of deficit countries to balance their accounts may, to that extent, reflect structural features of the economy of the surplus country or countries. On the other hand, a country that overexpands domestic demand in relation to its resources will tend to draw in imports from the rest of the world in excess of its capacity to pay for them through imports, and, thereby, generate surpluses in the current accounts of other countries.

While the Fund has the means at its disposal for dealing with deficit countries that come to it for assistance, there is little it can do towards effective remedies for the former type of imbalance. Fund members recognize, in principle, that persistent surpluses should not be permitted to lead to general world economic deflation, and that the correction of international disequilibrium calls for cooperative action by surplus and deficit countries alike. Implementation of this principle, however, gives rise to great difficulties in practice. On the one hand, surpluses have been so large that the balance of payments financing available in the system has not sufficed to avoid deflationary tendencies. On the other hand, it is difficult to determine, in individual cases, the extent to which pressure on the balance of payments of a particular country is the mirror image of surpluses elsewhere in the system, or reflects imbalances of domestic origin. There is, therefore, a tendency to ignore the former aspect, and to assume that the required degree and pace of adjustment are those that will restore balance quickly with as little recourse to official financing as possible. Moreover, since the international community accepts, de facto, the persistence of chronic surpluses in the system, to the extent that pressure is brought to bear upon deficit countries to adjust rather than to finance their deficits (if, indeed, this option is open to them), this has the inevitable result of causing deficits to emerge in the external accounts of other countries. This process of cumulative contraction can continue indefinitely unless deliberately checked in some way. Because of these considerations, the international system of surveillance tends to implant a deflationary bias on the world economy as a whole, and on the developing countries in particular because many of them have no access to alternative sources of balance of payments financing. Indeed, the stagnation of the world economy since the 1974-75 recession is probably to be attributed in substantial measure to the deflationary impact of the persistent surpluses in the system and the inadequacy of the financing facilities available to deal with them.

There is, moreover, a tendency for the responsibility to adjust to be shifted by various means to the weakest countries in the system, and hence, for an undue share of the deflationary burden to be borne by them. The most obvious

way in which such shifts take place is through imperfections in the recycling process that result in an undue concentration of capital flows to the economically stronger countries, but the shift can also occur because of a low level of import demand or restrictions on imports in the trading partners of the weaker countries. In either case, the latter countries may be forced to seek Fund assistance and, hence, to comply with the Fund's requirements, even though their deficits may be the result of factors partly or largely outside their control.*

It may be noted that the Fund has recognized certain types of balance of payments need that are due to factors beyond the control of the countries concerned. Examples are deficits due to temporary export shortfalls or to the initial impact of the increase in oil prices; and, in both these cases, it is recognized that the usual short-term adjustment process would be inappropriate, even though efforts are needed to correct the rising imbalance. There are, however, many other cases in which at least part of the deficit incurred by a country is due to factors beyond its control, including the effects of international business recession. There is, nevertheless, no corresponding means whereby the Fund could provide finance on terms that would adequately reflect the source of disequilibrium.

The Annual Report of the Fund for 1978 makes the judgment that international payments relationships in that year "featured a maldistribution of current account balances among major industrial countries." (2) This statement suggests that a good deal of thinking may already have taken place about the characteristics of an internationally consistent pattern of current account balances. While the difficulty of establishing such a pattern on a country-by-country basis worldwide should not be underestimated, it is likely that some broad general guidance in judging the performance of individual countries could be derived from careful study of the matter.

In any event, it seems desirable that the Fund, in considering the steps to be taken in dealing with pressure on the balance of payments of a member country, should seek to distinguish between those sources of pressure that call for adjustment by the country concerned, and those sources - including the structural surpluses of other countries - that indicate a need mainly for financing, but not necessarily for

*(Ministers of the European Community have stated publicly that they are not prepared to accept larger deficits with the United States in order to permit that country to pay for its oil imports. Developing countries have much less freedom of action in resisting shifts of counterpart deficits, whether from the United States or from other industrial countries.)

domestic adjustment. Examination of specific cases should involve determination of the optimum path of adjustment that would be desirable for a country if adequate finance were available, taking into account the need for consistency between short- and long-term objectives. To the extent that Fund resources are inadequate for this purpose, there is a need for an increase in the recycling of resources through the Fund, with a view to ensuring that countries are not forced to adjust in inappropriate circumstances, or to an extent that their own performance does not warrant.

In the case of the structural surpluses generated by the rise in oil prices, the Fund recognized that "attempts to eliminate [the counterpart deficits] through deflationary demand policies, import restrictions and general resort to exchange rate depreciation would serve only to shift the payments problem from one oil importing country to another and to damage world trade and economic activity." (3) Accordingly, an oil facility was created within the Fund to channel the flow of capital from surplus to deficit countries, though, as the Fund emphasized, "In the case of the developing countries official financing arrangements are clearly not adequate, even with the Fund's new oil facility." (4) But the surpluses of the oil-exporting countries are only one aspect of the matter. At least equally important, in quantitative terms, are the export balances of certain of the industrial countries, notably the Federal Republic of Germany, Japan, and Switzerland. The combined current account balance of these three countries in 1978 was expected to be of similar proportions to that in 1977, when it amounted to \$22.5 billion. The current account balance of major oil-exporting countries was expected to total \$20 billion in 1978. (5) In the course of his address to the 1978 Annual Meetings of the IMF and World Bank on September 25, 1978, the Minister of Finance of the Federal Republic of Germany stated that "An economy which for more than two decades became accustomed to produce external surpluses cannot easily adjust to current account equilibrium. As everywhere, structural changes take time and organizational imagination. Excessive and rapid exchange rate changes would undermine confidence which still is the main basis for investment and growth."

The case for allowing structural change in the surplus countries to be phased over an adequate period of time is no doubt a compelling one, but only if a similar phasing of the adjustment process is accepted as appropriate for the countries incurring the counterpart deficits. It is a serious inconsistency in the present situation, and a major source of international disequilibrium, that surplus countries are permitted an indefinite period of time in which to adjust their surpluses downwards while counterpart deficits must be adjusted within the standard periods provided under IMF

standby arrangements. Indeed, if all other countries were successful in eliminating their deficits in short order, the surplus countries would be forced into precisely the kind of disruptive adjustment that they are trying to avoid. There is no reason why surplus countries should not stretch out their own adjustment process provided that they are prepared to finance their surpluses at long term and ensure sufficient recycling through the Fund and World Bank to the countries faced with the counterpart deficits. The fact that it may be difficult to identify the counterpart deficits is no reason for maintaining the present inconsistency of policies, and for not seeking the best approximation to a consistent approach that is feasible in the circumstances. By the same token the case for avoiding hasty exchange rate changes in the surplus countries is equally applicable to the deficit countries, to the extent that their deficits are the counterpart of structural surpluses elsewhere in the system. The surplus positions of certain of the oil-exporting countries involve some additional considerations. In particular, to the extent that they are called upon to supply oil to the world economy in excess of their current requirements for imports, it is natural that they should seek to acquire counterpart assets of their choice. Here, too, however, it is necessary to avoid consequential pressures on the balances of payments of other countries, especially the poorer and weaker countries, and hence, to recycle a sufficient volume of resources to the counterpart deficit countries.

FRAMEWORK AND OBJECTIVES

The country studies reflect a wide spectrum of experience regarding the impact of balance of payments disequilibrium and the process of adjustment to this disequilibrium. In some countries, the pressures on internal stability and external balance were so severe that they interrupted the entire process of growth and development. In others the pressures, though disruptive, could be dealt with in a manner consistent with an early resumption of more normal development patterns. In a few cases, it even proved possible to turn the crisis to advantage by mobilizing new efforts in a manner that made it possible not merely to overcome the immediate difficulties but to move ahead even more strongly than before. This suggests the importance, at both national and international levels, of placing the adjustment process in the broader context of long-term development strategies and needs. A period of adjustment should be nothing more than an episode in a long-run process, and it is, therefore, indispensable that the categorical imperatives of the short run should not be allowed

to dominate, and perhaps even overwhelm, the requirements of the long run.

This means that both national and - to the extent that they become involved - international authorities need to address the problem of consistency between adjustment and development in a conscious and carefully articulated manner. There is often a tendency to regard domestic fiscal and monetary balance as a precondition for healthy development, so that the restoration of balance, once it is disturbed, is considered to take priority over all other objectives. But this implies too narrow a view of the adjustment process. It tends to neglect the fact that, in many cases, the restoration of equilibrium in the balance of payments in any meaningful sense calls for structural shifts that can be achieved only in the process of development. An obvious example is the adjustment to higher fuel prices, involving a process of long-term industrial change that may require investment in alternative sources of energy, as well as in industrial technologies that economize on fuel. The oil facility of the Fund was designed to take some account of this kind of problem, since the facility was intended to permit medium-term financing of oil deficits that would give some time for the structural adjustments to be made that would realize economies in the use of energy. But this was only one example of a whole series of cases in which essentially similar problems of long-term adjustment arise.

Consequently, if it is to be effective for more than a brief period, adjustment cannot be limited to reducing the level of aggregate demand to the extent required to minimize pressures on the balance of payments or on domestic prices. Where such pressures are of domestic origin, they usually reflect the existence of some obstacle to noninflationary growth that the authorities were unable to overcome. A particularly important obstacle of this type is rigidity in the supply of key wage goods or of certain special skills or material inputs. Another obstacle often encountered is the difficulty of introducing and implementing an equitable system of taxation. A mere reduction in demand may return the economy to its previous position, but the obstacles will probably persist unless dealt with explicitly and directly, and the pressures will emerge once more as soon as the development process is resumed. There is, therefore, a need for measures to tackle the basic causes of disequilibrium and the long-run obstacles to growth along with the proximate phenomena of inflation and balance of payments pressure.

Indeed, one of the key elements in working out an appropriate stabilization strategy should be a review of the development plan or program of the country concerned with the objective of minimizing disruption of long-run development. While, in a sense, this is always the tacit, if not explicit, objective of stabilization programs, the short-run emphasis of

such programs tends to sidestep the attainment of that objective. Certainly, one of the most disturbing features of the experience of adjustment reviewed in chapter 2 is the large number of cases in which there were major declines in investment growth.

Neglect of long-run implications is most easily seen, perhaps, in the type of arrangements often made for the refinancing of debt, though it should be borne in mind that the Fund does not control such refinancing. The "short leash" approach often implies that relief is given for a relatively short period at high cost, after which the debt service burden increases once again. In the event that exports have not made a major advance in the meantime - a likely prospect if external demand continues to stagnate and if investment has had to be curtailed - further relief may have to be sought, and new restrictions on the level of domestic demand and business activity may have to be accepted. In such a situation, even the most efficient management of the economy by the government will not suffice to overcome the uncertainties resulting from the debt position, which will act as a strong discouragement to investment, and especially to those types of inherently risky investment that are needed most for structural change and the development of new capacities.

It is generally the intention of stabilization programs to cause minimum interference with productive investment, so that the burden of adjustment is absorbed to the greatest extent possible by consumption. But whether this intention is realized will depend on the acceptance of falling consumption levels by the population as a whole. Failing this, the impact will be shifted to investment, especially if popular resistance takes the form of wage demands that have the effect of stepping up the momentum of cost inflation. Here, again, the types of investment that are most essential for long-run development will be affected most, while unproductive forms of investment - such as the hoarding of commodities - will flourish. Nor can it be taken for granted that the level of total output is assured so that a fall in consumption will inevitably be accompanied by a corresponding rise in investment. Since the expected level and rate of increase of consumption are major determinants of investment, a decline in consumption will be associated with an advance in investment only if investors have reason to believe that the decline is a strictly temporary one. If a country has been in difficulties over a lengthy period, it may face enormous obstacles in reestablishing investor confidence, and certainly a decline in consumption cannot be expected to contribute to such confidence merely because it releases resources; it may just as well depress confidence still further.

It is not suggested that solutions to these problems are straightforward, or that there are simple formulas for achieving them. The implication of the present discussion is, rather, that simplistic formulas and aggregative performance criteria of the type usually employed in stabilization programs do not satisfy the requirement that short-run remedies be reconciled with long-run goals. At the very minimum, one would expect that provision should be made for investment targets to play an essential role in stabilization programs. It would be inappropriate to include such targets among the performance criteria because governments do not control the level of private investment, and because of the uncertainties involved, some of which were noted above. But stabilization programs should explicitly consider the manner in which investment will be sustained and oriented so as to deal with the sources of current difficulties. Moreover, a decline in productive investment of more than temporary significance should be taken as a *prima facie* indication that a stabilization program is not achieving one of its principal goals, and that changes in the program, including the volume of assistance provided, may be needed.

In this context, sectoral considerations may well be of decisive importance - particularly considerations related to improvements in the domestic supply of food or energy, or to industrial diversification for export expansion or import substitution. A variety of measures and incentives may be needed for this purpose. Moreover, where balance of payments difficulties are due to factors other than excessive pressure of domestic demand, the sectoral allocation of credit may be a much more important object of concern than the rate of domestic credit expansion. As members of the Fund staff have pointed out in a study of credit policies in developing countries, "policies of an allocative nature have been either not given the importance due to them, or, if resorted to, were enmeshed with quantitative monetary policies in such a way that they lost their character in process of implementation." (6) One of the obstacles in devising stabilization programs that would seek a conscious reconciliation of short-term adjustment with long-run growth is that the present approach to such programs is highly aggregative, and depends on the assumption that economic performance can be accurately measured in terms of a few quantitative indicators. It is to this aspect of the matter that we now turn.

PROBLEMS OF DIAGNOSIS AND
FINANCIAL PROGRAMMING

The Fund History(7) describes the IMF's approach to financial programming whereby a set of monetary and fiscal policies can be determined for the next 12 to 18 months "that would reconcile resource availabilities with resource needs in such a way as to produce minimum strain on the member's domestic price level and a desired balance of payments result." Advanced econometric techniques are employed with a view to summarizing the monetary picture of a country in terms of a few aggregate figures. This makes it possible for the Fund to work with members to devise specific credit ceilings and targets suitable for inclusion in standby arrangements and to review the performance of members under these arrangements. Some of the concepts and basic models employed in this work have been analyzed in a collection of essays published by the Fund,(8) as well as in the Fund's voluminous Staff Papers. These publications provide a wealth of material on the broad approach adopted. But the reader inevitably encounters some difficulty in assessing the manner in which this approach is applied to individual country situations, since circumstances differ from case to case and particular results emerging from a model may have to be modified through the application of judgment.

The Fund is, itself, well aware of the many legitimate questions that may be raised concerning the methodology employed. The Fund History, for example, indicates that much remains to be done in considering such questions as: To what extent is a monetarist approach - that is, one based on the assumption that changes in the stock of money are a primary determinant of changes in total spending - valid for all countries? Are there not important intercountry differences in the manner in which monetary influences affect real output, employment, and price levels? How do programs based on credit ceilings affect domestic employment and the distribution of income? Are aggregative techniques useful for influencing such socioeconomic objectives as enhancing employment and redistributing income?(9)

Further questions emerge from an important article published by the Fund suggesting that the monetary approach to the balance of payments "needs blending with other lines of analysis."(10) Major qualifications of the monetary approach, it is suggested, are necessary in respect to the time dimension of the theoretical mechanism; the assumptions with respect to the income velocity of money; the unduly sharp dichotomy between "money" and other financial claims; the analogous distinction between "reserves" and other external assets; the broad assumptions usually made about capital mobility, the

substitutability of goods and services produced in different countries or sectors, and the existence of full employment conditions; the scope for more symmetrical application of sterilization policies; and the need for qualitative judgment.

Elaboration of one or two of these points may be helpful in indicating the character of problems encountered. The Fund staff recognizes that the apparent simultaneity, in the past, between credit expansion and imports was probably often due to the fact that credit expansion alters in response to changes in the need for money created by changes in imports, or to the fact that a common cause affects imports and credit expansion simultaneously. "It does not follow that a change in policy in regard to credit expansion would act on imports with anything like the same speed." (11) Doubts along these lines are reinforced by the reflection that large changes in gross money creation may be, at least temporarily, offset by changes in velocity of circulation. Indeed, historical variations in velocity would probably have been larger had not the responsiveness of credit expansion or capital movements to changes in the scarcity of money rendered such variations unnecessary. Consequently, as the staff points out, the historical evidence creates no presumption that velocity would remain steady if domestic credit were manipulated for policy purposes. (12) In addition, a further staff study suggests that the velocity of circulation of money was not stable in the developing countries during the period examined (1953 to 1968), and that prediction and economic policy based on the assumption that it was would be subject to substantial error. (13)

The above observations with respect to velocity have a bearing also on a basic relationship posited in some of the models employed, namely that GNP in current prices is a stable and increasing function of the money supply. Only by virtue of the assumption that velocity is stable can changes in the money value of GNP be deduced, as provided in such models, from changes in net domestic credit and in international reserves. The full employment assumption may also be critical in those models that employ it, since it is usually a strategic element in reaching the conclusion that an increase in demand from the existing level will affect prices but not output. Whether the full employment assumption is legitimate in any particular situation is, of course, something to be demonstrated, not assumed. The analytical complexities referred to in the Fund sources cited, and the need to reconcile various analytical approaches as well as to introduce broad qualitative judgment, are bound to mean that cases will occur - perhaps frequently - in which honest differences of opinion will emerge as to the diagnosis to be made, the targets to be set, and the measures to be applied.

It is particularly important for the methodology employed to be capable of distinguishing cases in which the predominant

feature is excess aggregate demand from cases in which cost-induced inflation or wage-price spirals are the key elements. Often these factors may be present together in a given country at a particular time, but it is still necessary to ascertain as accurately as possible the relative importance of each. While the conceptual distinction between these factors is no longer as controversial as it used to be in the days when the possibility of cost-induced inflation was denied even in principle, the analytical techniques employed may fail to provide the basis for detecting the difference in practice. This is a danger inherent in the effort to sum up the economic situation of a country in terms of a few monetary aggregates. The mere statistics of domestic credit expansion, for example, throw no light on the question of whether the expansion simply accommodated government and business requirements in the face of rising costs - without any expansion in real demand - or whether the credit expansion was itself a causal factor in generating excess demand. In most of the countries studied, it was the former situation that prevailed during the 1970s rather than the latter. Accurate diagnosis is, of course, of the highest importance because the remedies for excess aggregate demand are generally quite different from those for cost-induced inflation, as will be shown subsequently.

A further complication is the natural temptation to concentrate attention on elements of the situation that are quantifiable as against those that are not. One of the attractions of the monetary approach to the balance of payments is precisely that it lends itself to sophisticated econometric analysis. Unfortunately, it cannot be taken for granted that the correct ranking of factors in terms of their relative importance in bringing about economic change has anything to do with whether or not they are quantifiable. The quality of an economic program - the direction that it sets for the economy and the effectiveness with which it mobilizes resources to that end - is likely to be of greater significance than the quantitative targets per se.

TARGETS AND INSTRUMENTS

Standby arrangements for drawings on the Fund's regular resources are subject to an understanding between the Fund and the member country concerned as to the stabilization program to be pursued, which is set out in a letter of intent from the country's authorities. Standby arrangements for purchases beyond the first credit tranche include performance clauses setting forth specific targets that the country must attain. Two purposes are served by these clauses: they provide a means whereby the Fund can evaluate the

implementation of a member's stabilization program, and they are designed to give a country a guarantee as to the conditions under which it will be able to draw on the upper credit tranches. As the General Counsel of the Fund has indicated: "Performance criteria are invariably objective in character, in the sense that a subjective judgment is not necessary in order to ascertain whether they are being observed, with the result that a member will know at all times whether it is able to make a purchase." (14) Indeed, in the event of nonobservance of performance criteria by a member, the right to draw on the Fund is discontinued without the need for a decision by, or even notice to, the Executive Board. (15) However, standby arrangements provide for countries to "remain in close consultation with the Fund" (16) during the period of the arrangements, affording an opportunity for review of the conditions in which drawings could be resumed with the agreement of the Fund. The precise number and content of performance criteria applied appear to vary from country to country, to some extent. All standby arrangements provide for a ceiling on the net domestic assets of the central bank or of the banking system, and most of them contain a subceiling for credit supplied to the government by the central bank or banking system. Where debt service ratios are relatively high, a ceiling is usually placed on borrowing from abroad; provision is generally made for a minimum level of foreign exchange reserves; and the imposition of new exchange restrictions is invariably ruled out. These standard provisions may or may not be accompanied by other performance criteria such as the setting of a floor on bank reserve requirements; maintaining or increasing discount rates; the elimination of payment arrears; and undertakings to avoid new multiple currency practices, new bilateral payments agreements, and new import restrictions. Apart from differences in these respects, the arrangements seem to have varied also with respect to the scope of restrictions placed on foreign borrowing. At one time, restrictions were limited to loans with maturities of up to five years, but subsequently maturities of up to eight, ten, twelve, or even fifteen years were made subject to restrictions.

A number of matters may be the subject of agreements embodied in letters of intent signed by the governments concerned, or in informal understandings, rather than in standby arrangements. Prominent here is any change to be made in the exchange rate. There may also be understandings regarding efforts to limit the rate of increase in wages and salaries, and regarding the pricing policies of public enterprises and the elimination of subsidies. The difference between understandings that are and those that are not included within the framework of standby arrangements is probably more a matter of degree and procedure than of

substance. From a formal point of view, however, the letter is a declaration of intent by the government, while the standby arrangement is a decision by the Fund setting forth the circumstances and the terms by which a member may expect to obtain access to Fund resources under the arrangement.(17)

The foregoing performance criteria are given target levels for successive periods, usually on a quarterly basis. At the end of each period, the Fund checks compliance with the targets and, if the targets have been achieved, the corresponding fraction of the agreed drawing rights is released. The advantages of defining, in objective terms, the circumstances in which assured access to the Fund's resources would be given to a particular country are obvious. Unfortunately, there is a question as to whether the kind of cut-and-dried performance criteria that lend themselves to automatic application - without further judgment - can, in fact, provide a valid test of economic performance. Reference has already been made to the complexities and uncertainties arising in the areas of diagnosis and financial programming and to the unresolved questions noted by the Fund History and the Fund staff in this context. The same complexities and uncertainties occur in the process of target-setting, perhaps in an even more acute form since questions as to the reliability of the data base are even more significant in setting precise time-bound targets than in evaluating broad economic trends. As pointed out in the Fund staff article cited earlier, "Exclusive focus on any one of the monetary aggregates, or imputation of unique and overriding importance to its behavior, rarely proves fruitful". And again, regarding the efforts of officials to influence real economic activity or domestic prices or the balance of payments through policy measures, the following comment is of particular interest: "Their tools are too blunt, and the routes of transmission by which their actions are brought to bear on the economy (including the external sector) are too pervasive to allow pinpoint targetry." Only through a combination of objective judgment with quantitative analysis can effective results be obtained.(18)

Experience points clearly to the dangers of unduly rigid reliance on quantitative targets, however determined. In one of the countries studied, the government felt unable to accept the ceiling on government borrowing proposed in the course of negotiations on the grounds that it was unrealistically low. What the negotiators did not realize was that at the conclusion of their discussions the ceilings originally proposed, and maintained throughout the negotiations, had already been exceeded, so that when the data revealing this fact became available, no drawing on the Fund could be made.

The Governor of the Bank of England, in the course of a lecture in February 1978, indicated the enormous errors made

in the United Kingdom in forecasting even the public sector borrowing requirement (PSBR), let alone the prospective volume of bank lending to private borrowers.(19) He indicated, for example, that since 1974 the mean error of forecasts of the PSBR made at the beginning of each financial year had been on the order of £3 billion: the average annual level of the PSBR from 1974/75 to 1977/78 was £8.2 billion. It is, of course, nothing new that estimates of residuals, however arrived at, are subject to large margins of error, but this is exactly the kind of problem that governments are up against in seeking to regulate the progress of the economy. It is important that difficulties of this kind should be reflected in the management techniques adopted, which, necessarily, have to be flexible. Above all, the foregoing experience illustrates the pitfalls in supposing that there are ways of setting performance criteria so clear, so objective and so precise, that no further judgment is necessary in order to ascertain whether they are being observed. For this and other reasons the Governor of the Bank of England was sharply critical of procedures that would require a particular numerical target to be reached by a particular date: "Firm deadlines can force one either to try to adjust too fast to an unforeseen trend developing late in the period, or to appear to accept a failure to reach one's target."(20)

One of the points emerging from the country analyses is that, while in some countries the authorities appear to have understood the methodological basis for the Fund's determination of the targets and associated policy measures required, in others the reasons for the targets and policies prescribed were less well understood, especially where exchange rate adjustment was under consideration. This, together with the existence of the unresolved questions noted earlier, suggests that there may be a case for publishing sufficient information on the methodologies currently in use to permit governments and scholars to appraise the work that has been done, in a spirit of open and constructive inquiry. The Fund has already done a great deal to this end, as will be apparent from the references cited earlier. But the material published is usually at a fairly high level of generality and abstraction. Obviously, there cannot be any question of publishing confidential details of individual cases, nor is this necessary for the purpose envisaged. Short of this, however, it would still be possible to throw sufficient light on the Fund's precise methodology in dealing with various categories of country and various types of problem to permit a useful dialogue to take place on the nature and impact of the techniques applied and policies recommended, and on their compatibility with nonmonetary goals of the international community, particularly the long-term goals of growth, development, and social equity. Finally, it would be

advantageous if governments considering the possibility of applying for a standby arrangement provided their own diagnosis and plan of action to form the basis of discussion with the Fund. This already happens in some cases, but not in all.

Turning now to the instruments of adjustment, the Fund's position is that it does not prescribe the way in which the targets agreed upon with governments are to be achieved. The Fund may make recommendations reflecting its views as to the most effective means for reaching the targets, but it does not make its offer of assistance conditional on the adoption of one course of action rather than another. There are, however, a number of rather major qualifications to be made. In the first place, certain types of policy are ruled out and there are others that should, in the view of the Fund, be avoided (examples will be cited subsequently). Secondly, it is inevitable that the selection of targets largely determines the character of the adjustment to be undertaken. The most important target is usually considered to be a ceiling on domestic credit expansion and the corresponding policies involve global fiscal and monetary restraint, regardless of the source of balance of payments pressure. To the extent that a balance of payments deficit is due to excess pressure of demand on domestic resources, it is natural that the solution should be sought in a general curb on demand. But, in many cases, a significant and often major proportion of the deficit is due to factors that do not lend themselves to treatment by generalized deflation. Reference has already been made to that part of the deficit that is the counterpart of current account surpluses elsewhere in the system. But external deficits may also reflect a structural decline in world demand for the products exported by a particular country, or sectoral problems in the domestic economy due, for example, to a need to bring about the kind of reforms in agriculture that would lead to an expansion of food supplies or to shift to cheaper and less import-intensive forms of energy. Adjustment to imbalances of the latter type calls for specific policies and measures adapted to the particular problem. In such circumstances, reliance on global monetary and fiscal policies as the main instruments for balance of payments adjustment may necessitate a higher proportional decline in real income for a given improvement in the balance of payments than would otherwise be required. In most developing countries, exportable supplies are increased relatively little by monetary and fiscal contraction, while imports are not easily compressed, especially where they have already been limited by direct controls, so that it takes a relatively large cut-back in domestic income to achieve the further reduction in imports required.

The Fund has, of course, recognized that under conditions characterized by prolonged and severe cost-price spirals, the normal application of deflationary measures would be disruptive and would create a conflict between the requirements of external balance and of domestic development. It was in order to permit more effective handling of such situations that the Extended Fund Facility was created, to provide assistance in amounts beyond 200 percent of quota if required, as well as for a longer than normal period of repayment. This important step forward should, however, be accompanied by a diversification of policy approaches since, even over a longer period, reliance on general fiscal and credit contraction alone may be ineffective unless it is the intention that the policies should be applied in a manner so severe as to break the resistance of the employers and workers concerned - a course of action that is likely to be disruptive as well as wasteful of resources. No country, whether developed or developing, has found a fully satisfactory solution to the problem of cost-price spirals. The most promising approaches probably lie in efforts to deal directly with the factors that prompt excessive wage claims or excessive price adjustments - such as curbing increases in the cost of wage goods, tackling problems of wage differentials, monitoring prices increases, and, above all, seeking a consensus as to tolerable rates of increase in wages and prices. Where voluntary methods fail, some governments may be prepared to exert strong pressure through tax and other policies or may, ultimately, resort to direct wage and price controls.

It should be emphasized that what is at issue here is not whether fiscal and monetary policies are useful or whether monetary targets are necessary. The point is, rather, that rigid policies of any kind are to be avoided and that, while it is essential for policy to have a sense of direction, emphasis on pinpoint targets is likely to be misplaced, if only because of the unreliability of the basic data. Finally, while fiscal and monetary restraint may often be the most important requirement of a stabilization program, this is not always the case by any means; and, by the same token, attainment or nonattainment of a target for domestic credit expansion is not necessarily the most crucial indicator of effective performance, especially where the primary source of difficulty is sectoral rather than global.

It is also necessary to balance considerations of monetary and payments stability with those of equity. Explicit attention to the distribution of the burden of adjustment among various segments of the population is needed. For example, a tight monetary policy tends to favor those who are in a position to obtain loans abroad. Apart from the fact that those who borrow abroad may virtually escape the effects of the

tightening of credit, they may also make large profits by taking advantage of interest rate differentials associated with steep increases in domestic rates. Likewise, devaluation may bring windfall profits to primary producers at the expense of the urban and rural poor. In at least two of the countries studied, particular objections were raised by the Fund to the continuation at existing levels of subsidies on essential foodstuffs because of the heavy cost to the government budget. While a reduction of subsidies may be effective in reducing the budget deficit as well as imports, it tends to bring about a deterioration in the distribution of real income and consumption at a time when international development agencies such as the World Bank are calling for greater concentration of resources on satisfying the basic needs of the poorest countries, and of the poorest communities within these countries. Of course, in this, as in other respects, it is a matter of judgment how far the government can afford to go. In some cases, the cost of subsidies has risen to the point of interference with other major goals, notably the goal of generating an adequate surplus of public savings for development. All that can be said is that, while there are no valid grounds for opposing subsidies in principle, circumstances may indicate that particular subsidies at particular levels appear excessively burdensome in view of competing claims on public resources. Nevertheless, it is for each government to decide how public resources should be allocated in the light of the country's social priorities, and how such allocation can be reconciled with external balance within a reasonable period of transition.

Differences in point of view have also emerged on questions of broad political and economic philosophy. In one case, an effort was made to persuade a government to "dismantle" its system of price controls, presumably because of a concern that such use of direct controls on the economy would suppress symptoms of disequilibrium or of misallocation of resources, and that prices would not provide the market signals needed. This, however, is a controversy that cannot be settled on the basis of conventional economic logic alone, especially in view of the limited effectiveness of market forces in providing unequivocal signals in a world remote from the neoclassical assumption of a fully employed and competitive economy.

Prices perform a number of functions; they not only serve as market indicators but also play a critical role in the distribution of income. In some situations, especially situations of acute inflation, satisfactory performance cannot be achieved simultaneously in both these respects. A course of action that may be efficient from the one standpoint may be inefficient from the other. The choice of priorities is, then, essentially a political one, and only the government can take responsibility

for that kind of decision. Moreover, where price controls are employed as an integral element of the planning mechanism for the allocation of income and resources, their elimination is not a technical question, but a question of basic political and economic strategy that is, once again, a matter for decision by the government alone.

CONDITIONALITY AND THE USE OF RESOURCES

In some of the countries included in the present study, the conditions for drawings under standby arrangements with the Fund raised no problems; full agreement was reached without difficulty on targets and policy measures alike. In several cases, however, targets and policy measures were the subject of intense, and sometimes prolonged, debate between government and central bank authorities on the one hand and Fund missions on the other. It would not be possible, for obvious reasons, to evaluate the issues involved in individual cases. The present account is, therefore, limited to an examination of the general issues, without supporting detail from individual countries. The exposition inevitably loses specificity thereby, but this does not prevent discussion of the essential points at stake. A third category of countries, notably Brazil, India, and the Ivory Coast, took a policy decision to avoid drawings on the upper Fund credit tranches because of their concern that the conditions that would be applied would be unacceptable to them. In a statement made to parliament on May 15, 1978, the Minister for External Affairs of India explained the circumstances in which India sought and obtained a loan of \$250 million from Iran in 1975:

The attempts to negotiate such a loan started in July 1974. This was at a time when, following a steep hike in oil prices, India was faced with a very severe balance of payments problem. Government was reluctant to make additional drawings from the IMF because of the stiffer conditions attached to drawings from IMF in higher credit tranches.

The IMF has itself documented the sharp decline in recourse to the upper credit tranches of the Fund in recent years.⁽²¹⁾ Although roughly the same proportion of countries (including both developed and developing countries) had deficits from 1967 to 1969 and 1974 to 1976, deficit countries had net recourse to Fund resources twice as often in the latter period as in the former. Despite this, the importance of purchases in the upper credit tranches declined markedly in the latter period. In deficit periods prior to 1974, 58 percent of the net

purchases in the credit tranches extended into the upper tranches, while in deficit periods from 1974 to 1976, only 19 percent of such purchases extended into the upper tranches. This may be attributable in part to the greater availability from 1974 to 1976 of alternative sources of balance of payments financing, including resources available within the Fund itself under the oil facility and compensatory financing facility. But there is no doubt that, even where countries were under the most intense pressure, both in their external accounts and in their domestic economies, they hesitated to make use of the upper tranches of their quotas in the Fund, and avoided it if they could. There were only ten cases of drawings beyond the first credit tranche from 1974 to 1976 among the entire Fund membership. Thus, quite apart from questions of the general adequacy of international official resources for balance of payments support, and as to whether the present balance between official and commercial sources of balance of payments finance can be regarded as satisfactory, there is a further question as to whether the official resources that do exist are sufficiently "available" for the purposes intended.

In the course of an address on May 8, 1978, the Managing Director of the IMF, referring to the contention that the rate of adjustment required by the Fund is too rapid, pointed out that "all too many countries approach the Fund for financial assistance only when, as a result of protracted delay in taking corrective action, the economic situation has already become critical. Under such circumstances, it is inevitable that at least the initial corrective measures would be painful." (22) This point is clearly confirmed in several of the countries included in the present study. At the same time, the reasons for delay in each particular case would warrant some attention. There is a widespread feeling among developing countries that the quota resources available in the Fund are too small to justify the considerable changes in economic plans and policies that might have to be made in order to be allowed to draw on these resources, except as a last resort in circumstances leaving no other option open to them. There may thus be a vicious circle involved. On the one hand, the Fund acquires a reputation for imposing unduly severe conditions because countries do not apply for drawings until their situations are critical, and severe conditions become unavoidable. On the other hand, countries delay their applications to the Fund for assistance until the last possible moment because they act in the belief that the Fund's conditions for drawings in the upper credit tranches are stringent at all times, particularly the inhibitions regarding general economic policies.

It would appear that this vicious circle is unlikely to be broken unless it can be demonstrated that it is clearly advantageous in practice for a country to consult the Fund at

a relatively early stage of the evolution of a balance of payments difficulty. It is unclear whether, in dealing with early applicants, the Fund would be prepared to ease its stand on questions of general economic policy - questions relating, for example, to direct controls on domestic transactions or foreign trade, the use of subsidies on consumption of basic foodstuffs, pricing policies of public enterprises and so forth. There is, in any case, a basic question as to whether the Fund's mandate requires it to take a view on such matters at any time, or whether the Fund should not rather be prepared to operate within the broad policy framework established by each government. But certainly, as a minimum, the Fund could make a clear distinction between early and late application for drawings in the upper credit tranches by being prepared to apply first credit tranche conditionality to the later tranches for early applicants. A more general easing of Fund conditionality would, however, be justified along the lines proposed in the annotated agenda for the Group of Twenty-four's twenty-sixth meeting of Deputies and seventeenth meeting of Ministers. Those proposals were summarized by the Ministers in the following terms:

Regarding conditionality in the use of Fund resources, the Ministers expressed concern at the multiplicity of performance criteria and some other forms of conditionality that inhibit access to Fund resources by member countries. Hence, they urged the Executive Board of the IMF to set appropriate guidelines and establish other institutional procedures related to the use of Fund resources, especially in the upper credit tranches, in support of economic adjustment programs. In this context, they were of the view that the guidelines should be designed so as to limit the performance criteria only to relevant macro-economic variables, paying due regard to the growth considerations of member countries, and their prevailing economic and social situations. (23)

The main conclusions suggested by the preceding discussion are:

1. The measures required for satisfactory adjustment cannot be reduced to standard formulas, nor can performance be judged by pinpoint targetry. There are many situations, notably of excess demand, in which the curtailment of credit must inevitably play a central role; but equally there are others - such as those in which balance of payments

difficulties are accompanied by falling production and employment, or by supply bottlenecks in particular sectors - where general credit contraction, if employed at all, should certainly not be the centerpiece.

2. Stabilization programs should indicate objectives and directions for the economy. To the extent that such objectives and directions need to be accompanied by quantitative targets, such targets should be expressed in terms of ranges rather than of exact figures, the ranges being determined by taking account of the lack of precision in the operation of policy instruments as well as of the orders of error in forecasting.
3. The package of measures proposed for adoption should be sensitive to the particular situation of each country, including the political and social philosophy underlying its development program, the level of development and degree of flexibility and diversification of its economy, the extent to which its balance of payments difficulties are of internal or external origin, and the impact of the package on long-run development prospects.
4. The low degree of utilization of the upper credit tranches of the Fund suggests that the conditions required for drawings in these tranches have become too demanding in relation to the amount of resources made available. It appears, in fact, that the point has been reached at which the rigors of conditionality have begun to reduce the effectiveness of the Fund's cooperation with member countries, by preventing them from approaching the Fund except in the most extreme circumstances. Both for this reason, and on the merits of the case, an easing of conditions seems justified.

TRADE POLICIES

The Fund considers that restrictions on trade are not an acceptable means of tackling balance of payments pressures, and that such restrictions may, in fact, be said to compound the problem of adjustment instead of dealing with it. While it is recognized that certain long-standing restrictions may be difficult to remove in the short term because of the effect that this would have on production and employment, the Fund requires that stabilization programs should provide for removal

of restrictions newly imposed for balance of payments reasons, and for renunciation of any further recourse to them. Provisions to this effect are common in standby arrangements, as noted earlier.

The Fund's strong position on this matter may be traced back to Bretton Woods, when a major concern of the participating countries was to liberalize the many restrictions on trade and payments that had been introduced during the war and postwar periods and to avoid relapsing into the beggar-my-neighbor trade and exchange policies characteristic of the 1930s. The policy of liberalization made rapid headway during the 1950s and 1960s, and this contributed to an unprecedented growth of world trade. During the 1970s, however, the situation has changed; and, particularly recently, the liberalization process has slowed down and has, in a number of respects, been reversed. In a report published in September 1977, the GATT Secretariat stated that the spread of protectionism had reached a point where "the continued existence of an international order based on agreed and observed rules may be said to be open to question." (24)

The new wave of protectionism, which strikes particularly hard at the so-called low-wage countries, is itself partly the result of the recession of 1974-75 in the industrial countries and of the slowness of the recovery that followed, accompanied by relatively high unemployment. In a deeper sense, however, it is a symptom of a failure of adjustment in developed countries. Even if measures restricting imports from developing countries are not imposed for balance of payments reasons - which is not altogether clear, especially in some of the industrial deficit countries - they certainly exert a significant and growing impact on the balances of payments of the exporting countries, and should, therefore, be regarded as raising serious questions for the international adjustment process as understood within the framework of the Fund.

The Multi-Fibre Arrangement expands the scope and increases the intensity of discriminatory restraints on shipments of textiles from developing to developed countries. These restraints date back to 1962, when the first international agreement of this kind, limited to cotton textiles, was adopted as a temporary measure to be applied "during the next few years." Thus, adjustment in the textile industry under broad international supervision has already lasted more than 17 years on a "temporary" basis, and the end is not yet in sight. The contrast between this and the rate of adjustment often required in cases of balance of payments difficulty that call for structural changes is too obvious to need emphasis.

The present climate of international trade is quite different from that of the early postwar period. The forward momentum of trade liberalization has been arrested, at least temporarily, and the question arises whether it is reasonable

to expect countries in balance of payments difficulties to be placed in the vanguard of new progress in this field, especially since at least part of their deficits may be due to import restrictions imposed by countries not subject to Fund surveillance, as well as to levels of activity and import demand in some of their main markets that the Fund considers lower than would be desirable in the circumstances.

It should be borne in mind that the liberalization of trade is not an end in itself. The purpose of the Fund in this regard is defined as being "To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."(25) In this connection, the argument adduced by the Fund itself for not interfering with long-standing restrictions on trade where this would be disruptive of production and employment is surely valid for newly imposed restrictions also, if it can be shown that the only alternative to such restrictions is a reduction in output and employment. If this were not so, one might face the paradoxical situation of condoning import restrictions on textiles because they were of long standing, while prohibiting controls on imports of other products in the countries suffering export losses under the new Multi-Fibre Arrangement.

The contention that restrictions suppress the problem of imbalance instead of dealing with it would have more force if the general climate of world trade were expansionist, so that redeployment of resources into sectors with an export potential would be clearly preferable to the restriction of imports. Of course, it should be borne in mind that, even in the latter case, a redeployment of resources of the sort envisaged could not be undertaken in developing countries within the time frame of a standby arrangement of one year, or even longer, any more than a redeployment away from the textile industry has been considered feasible in the industrial countries within such a period. Under current world trade conditions, especially as they affect developing countries, traditional approaches to the question of trade restrictions would appear to require some reconsideration. The case for direct trade controls is particularly strong where a country is forced into substantial deflation and unemployment as a means of reducing imports, and where the requisite import reduction could be achieved with a lesser decline in real income and employment if such controls were sanctioned. It is true that the Fund tends to be more lenient with trade restrictions than with exchange restrictions, and would probably be prepared to accept the substitution of trade restrictions for exchange restrictions. For example, it would probably prefer an increase in tariffs to

the imposition of delays on payments. The fact remains, however, that a number of the standby arrangements entered into with developing countries in recent years have contained performance criteria requiring that no new import restrictions be applied. Finally, in some countries, foreign exchange budgeting and import controls are regarded as indispensable tools for economic planning. As in the case of price controls, liberalization would imply abandonment of fundamental aims of the government, and cannot, therefore, be viewed solely in terms of the usual technical criteria.

POLICIES ON EXCHANGE RATES

Exchange rate changes are one of the essential instruments for adjustment, and all countries need to make such changes from time to time. As in the case of monetary and fiscal policy, however, there are no standard formulas that can be applied; the usefulness of exchange rate adjustment depends greatly on the particular circumstances of each case. The case for exchange rate adjustment is clearest where world market prices do not cover the domestic costs of export products, including a reasonable margin of profit, at current exchange rates. Beyond this point, however, the usefulness of the exchange rate weapon varies considerably from country to country depending on the degree of elasticity and diversification of the economy concerned. As the Fund staff has put the matter:

Where trade flows are responsive to price factors (as, for example, for developing countries which have a substantial manufacturing sector) there is more likely to be a balance of advantage in rate flexibility. . . . In other cases, however, where trade flows are not very responsive to exchange rate changes (because export prices are determined in world markets and there are no close domestic substitutes for imports) the exchange rate changes needed to secure equilibrium in the balance of payments will be large. For these countries, the repercussions of exchange rate variability on domestic objectives, such as investment promotion and income distribution, may be a more potent factor on the negative side.(26)

It is implicit in the above exposition that there are circumstances in which the negative consequences of exchange rate adjustment may be so important relative to the

advantages, that such adjustment should be undertaken only where no other remedy for the situation would be adequate. At all events, the mere existence of a balance of payments deficit does not necessarily establish even a *prima facie* case for devaluation. Apart from the potentially adverse impact on income distribution referred to in the above quotation from the Fund staff, so many of the basic costs of developing countries are tied to import prices that it may be impossible to prevent devaluations of large magnitude from setting off severe cost-induced inflationary spirals - and a cumulative interaction between inflation and devaluation - with all the attendant economic, social, and political dangers that this entails. The degree of reduction of effective demand required to avoid all risk that devaluation may trigger uncontrollable inflation may be unacceptably great, especially since forecasting the rate of acceleration of cost/price spirals is subject to particularly large margins of error. Only where governments have the power to prevent such spirals by direct action can these risks be avoided, though even in such cases experience shows that public unrest may build up to explosive proportions.

Thus, particularly where trade flows do not respond sensitively or quickly to exchange rate changes, the case for such changes cannot rely on routine calculations of purchasing power parities or on other generalized considerations. What is required is a careful analysis of the circumstances of each particular case that takes full account of the structure of the country concerned and the responses, both domestic and external, to be expected to changes in the exchange rate. Moreover, the degree of devaluation itself requires the most careful attention and justification because of the potential domestic repercussions.

THE RATE OF ADJUSTMENT AND THE ADEQUACY OF RESOURCES

Given the magnitude of the factors underlying disequilibrium in the balance of payments, the desirable rate of adjustment is that which minimizes costs in terms of output or growth potential foregone including the frictional costs of reallocating resources. The determination of an optimum rate of adjustment is, thus, a complex matter, especially since the factors to be taken into account go beyond purely economic considerations. At times, the shock effect of a crisis may create a mood of readiness for change among the people at large which undue prolongation of the adjustment process might erode. Moreover, where there is a danger that a situation may get out of control - for example, where there are signs of imminent hyperinflation - it may be essential to adopt drastic measures

with immediate impact. In other circumstances, efforts at unduly rapid adjustment not only may lead to serious disruption of major development programs but may provoke or exacerbate political tension and conflict. Thus, technical problems of optimization within a conventional social cost-benefit framework may often be of quite secondary importance compared with the broader social and political issues involved. While other costs may be assessed correctly, the costs of social strife are often overlooked, or not foreseen.*

It is natural and appropriate for international agencies to limit themselves to the technical aspects of problems as far as they can. They have no mandate to take political factors explicitly into account. Unfortunately, technical and political aspects can rarely be separated. The very act of pressing a technically valid solution to the limit may be unwise in a larger political context. It is important that international agencies should neither directly nor indirectly substitute their own political judgment for that of their member governments.

Political and social factors aside, the cost to an economy of having to compress the adjustment process into an unduly brief period could in principle be measured in terms of the losses in potential levels and rates of growth of consumption and investment. The expected path of consumption and investment in circumstances of rapid adjustment could be compared with alternative paths providing for adjustment over longer periods. A prerequisite for achieving and maintaining higher levels of consumption and investment than would have been possible within a shorter time frame for adjustment is, of course, a larger total volume of balance of payments support extended over a longer period. Assuming effective redeployment of resources, however, the additional funds borrowed could be repaid out of the additional output generated by the higher level of investment undertaken during the period of adjustment. In principle, the present value of the various output streams corresponding to different feasible periods of adjustment could be compared through the use of an appropriate rate of social discount, and that period of adjustment could be selected which yielded the largest surplus of expected additional output over the additional balance of payments financing required. There is, however, no

*It is noteworthy that in the course of an address on May 8, 1978, the Managing Director of the IMF expressed the view that the problem of disequilibrium had been "exacerbated in some parts of the world by an increase in the number of governments whose position was insufficiently strong to enable them to undertake difficult adjustment measures." (27)

indication that calculations along these lines were undertaken for any of the countries in the present study that sought standby arrangements - presumably because of the rather limited freedom of action of the Fund at the present time in determining the period over which adjustment is to take place and the correspondingly limited resources available for balance of payments support.

The country studies have shown that some countries were able to cushion the adjustment process by drawing upon commercial as well as official sources of finance. Several of them were, in fact, virtually able to determine for themselves, at any rate for a time, the amount of foreign borrowing that they would undertake. Owing to the criteria of creditworthiness applied by commercial banks, however, most developing countries had access only to official sources of finance, and these were quite limited having regard to the extent of adjustment required in many countries and the structural rigidities of the economies involved. It is clear that the period of adjustment was much too short for many countries, and a lack of adequate official resources for medium-term balance of payments support was severely felt. Although the Fund's oil facility made some contribution, the resources made available through this facility fell far short of requirements for the purpose in hand.

The disruption of development programs brought about by the compression of the balance of payments adjustment process into an unduly brief period of time had inevitable consequences for long-term growth. The impossibility of effecting a really meaningful separation between short-term balance of payments requirements and long-term development needs became more and more abundantly clear. As noted earlier, where a genuine adjustment process requires that the economy be restructured so that it can move ahead without generating internal or external imbalance, provision has to be made for medium- and long-run as well as short-run change, and corresponding financial resources are clearly required.

The Fund recognizes that the optimum rate of adjustment depends very much on the extent of imbalance and the degree of redeployment of resources required. In the past, when it was apparent that the adjustment needed could not be effected within the time frame of a one year standby arrangement, the rate of adjustment could be moderated through a series of successive arrangements over several years. More recently, it has become possible to adopt standby arrangements covering periods of up to two years; or arrangements under the extended facility which are, at present, available for periods of up to three years, with repayment falling due within a period of five to seven years.

While the new approaches are clearly a move in the right direction, they do not as yet amount to a full recognition of

the nature or dimensions of the problem. The Fund still considers the one year standby arrangement to be the normal procedure to be adopted, and the longer term arrangements as exceptional. This, however, amounts to prejudging the character of the imbalances that will be encountered over the coming years. There is no doubt that there are cases in which a substantial degree of adjustment can be effected within the space of one year. These are the cases in which the imbalance is relatively moderate and the source of difficulty is brought fairly readily under control without major disruption of the economy. But equally, there are cases in which the imbalance is large and persistent, and the remedies involve long-term structural change. Some of the most advanced of the developed countries have experienced imbalances of this type - both surpluses and deficits - that have proved difficult to bring under control even over periods of many years. The greater rigidity of the economies of developing countries exposes them to even greater difficulties of this type.

It is impossible to say in advance whether future requests for drawings on the Fund will be predominantly of the former or of the latter type, and it is, therefore, necessary to keep an open mind as to whether the one-year or the multi-year arrangements will be found most advantageous. If the world economy continues to be faced periodically with profound shocks to the system of the type encountered during the past several years, it would be reasonable to suppose that it is the extended arrangements that would be most appropriate, not those of one year.

If a slower rate of adjustment in appropriate circumstances is to be envisaged, the question of the adequacy of resources for balance of payments support comes to the fore. There has been a marked secular tendency for Fund quotas to fall in relation to the volume of world trade. Thus, Fund quotas declined from the equivalent of approximately 10 percent of the imports of member countries in the early 1950s to about 3 percent in 1977. Moreover, it is unlikely that the latter percentage will be significantly altered by the coming into force of the quota increases provided for in the sixth and seventh general revisions of quotas, because the projected rate of increase in quotas may not significantly exceed - if it exceeds at all - the rate of growth of imports. While allowance may also be made for the effect of nonquota Fund facilities, the extent of these has not been sufficient to offset more than a small proportion of the relative decline of the past 25 years.

It is true that relations between the Fund and the private banking system have recently become much closer, so that, in a sense, agreement between a member country and the Fund on the conditions for a drawing may be said to bring with it the possibility of a larger volume of balance of payments support than that provided by the Fund alone, though commercial

borrowing is usually subject to a ceiling in countries that already have a substantial burden of debt service. Borrowing from private banks is, at best, a poor substitute for adequate resources in the Fund, especially in view of the fact that there are great inequalities in the access of member countries to the private banking system and that the terms and conditions of private bank lending are inappropriate for low-income countries. Fund resources form a much higher proportion of the total balance of payments financing available to the weakest and - in terms of the narrow criteria of private capital markets - least creditworthy countries than they do for other Fund members. The weakest countries are those that can least afford to hold fully-owned reserves and thus, most likely to need Fund assistance requiring them to come under Fund surveillance. They are, therefore, in multiple jeopardy - they tend, through the process of shifting mentioned earlier, to attract more than their share of the pressures exerted by structural current account surpluses in the system, as well as a less than proportional share of the capital flows that these surpluses generate; they are least likely to be able to finance such deficits out of owned reserves or by borrowing from nonofficial sources; they are, therefore, most likely to have to comply with constraints upon their economies, the extent of which is a function of the inadequacy of available official financing; and they have the least capacity for adjustment because of the rigidity and lack of diversification of their economies. As an Executive Director of the Fund has pointed out in relation to drawings in the upper credit tranches, there is a danger "that those countries that have limited their foreign borrowing to Fund credit 'suffer' more from the Fund's conditionality than other countries that have borrowed abroad in the same overall order of magnitude but mainly from other sources." (28)

The adequacy of resources should also be viewed from the standpoint of the applicable terms and conditions. The idea that the maturities of balance of payments loans should normally be limited to periods of three to five years seems unduly restrictive. When originally adopted in 1952, the three to five year limitation was intended to ensure the revolving character of the Fund's resources. The limitation was not based on any reasoned proposition to the effect that it would be improper in principle to provide balance of payments support at maturities longer than five years. There is, therefore, a case for bridging the gap between short-term balance of payments accommodation and long-term development finance of the type provided by the World Bank. In this context, it is interesting to recall that some of the early plans for the Fund and Bank envisaged an integrated institution, and that during the Congressional hearings on the Bretton Woods Agreements in the United States, the American Bankers'

Association, through its President, sharply criticized the separation between the Fund and Bank as artificial and inefficient. One of the considerations adduced in support of this view was that stabilization programs might well require long-term loans.(29)

Certainly the problems that face a country in practice are a continuum; actions taken for short-term purposes may have profound implications for the long run, and vice versa. There is a need for the international agencies to find ways of appraising and dealing with the problems that face governments in a manner that is more realistic and less stratified by purely institutional considerations. There is also a need for additional financing facilities that would be addressed to the medium-term adjustment-cum-development problems that arise when countries are faced with imbalances that are so persistent that they do not lend themselves to resolution even within the time frame of the extended Fund facility.

4

Conclusions and Recommendations

The succession of crises in the world economy that began with the collapse of the Bretton Woods system in 1971 subjected the developing countries to the most severe test of their capacity for adjustment of the postwar period. Many countries faced current deficits in their balances of payments of unprecedented magnitudes. While a significant proportion of these deficits reflected imbalances of domestic origin, there were major external elements for which the deficit countries were either not responsible or at least not wholly responsible. Moreover, the deficits, large as they were, did not reflect the full extent of the difficulties faced. The fact that countries were forced to reduce production and income below otherwise attainable levels so as to bring their external payments into balance meant that recorded surpluses and deficits were smaller than they would have been if the existence of such disequilibrium had not in itself caused a constriction of output and employment. In effect, many of the developing countries were faced with a burden of adjustment out of all proportion to their degree of responsibility for the imbalances arising in the international payments system.

The principal sources of disequilibrium that were beyond the control of the deficit countries but which, nevertheless, imposed tremendous burdens upon them were:

1. the sharp changes in the prices of primary commodities, especially in 1974-75, and the acceleration of the upward trend in prices of manufactured goods imported by developing countries;
2. that part of developing country deficits that constituted the counterpart of structural surpluses in certain industrial and certain oil-exporting countries;

3. the shifting of balance of payments pressures from industrial countries to developing countries through the slackening of import demand in the former countries associated with the recession of 1974-75 and the period of low growth that ensued; and
4. the further shifting of pressures resulting from a growing wave of protectionism in the industrial countries directed particularly at imports from low income countries.

In 1974, the International Monetary Fund, referring to the structural surpluses generated by the rise in oil prices, had warned that "attempts to eliminate [the counterpart deficits] through deflationary demand policies, import restrictions and general resort to exchange rate depreciation would serve only to shift the payments problem from one oil-importing country to another and to damage world trade and economic activity."⁽¹⁾ This warning was not, however, fully heeded, at any rate as far as the effects of deflationary demand policies and import restrictions were concerned.

THE CHARACTER OF BALANCE OF PAYMENTS PRESSURES

A comparison of movements in the trade balances of both developed and developing countries between the periods 1962 to 1972 and 1973 to 1976 shows that in the latter period the frequency with which import price changes appear as a primary factor increased dramatically for all groups of countries, and the frequency of export price declines increased for all groups other than the large OECD countries. The sharp reduction in the frequency with which import volumes appear as a primary factor in deterioration in the trade balances of developing countries and the key importance of changes in foreign trade prices during the 1973 to 1976 period suggest that demand pressures emanating from domestic economies were far less important, relative to other causes of change in the trade balance, than had previously been the case. Consequently, at both the national and international levels, policies that assumed that excessive demand pressures were still the most important feature of payments problems were in need of review.

Owing to the inadequacy of official flows of finance (bilateral and multilateral) in relation to the balance of payments pressures encountered, a large proportion of the external financing was provided during this period by private capital markets. This enabled the recipient countries to

sustain a substantially higher level of economic activity and import demand than would otherwise have been possible. Private capital flows were, however, directed mainly to industrial countries and the more advanced of the developing countries. Many of the low-income countries were unable to secure access to private capital markets, and borrowing in these markets, in any case, involved terms that were inappropriate for these countries. Consequently, there was a pronounced bias in the recycling process against the poorest countries that were therefore required to bear more than their fair share of the burden of adjustment.

The problems arising from the increase in the general level of international prices and, for most non-oil-exporting developing countries, from the sharp deterioration in terms of trade were compounded by the additional pressures that were brought to bear on their balances of payments as a result of the recession in the industrial countries of 1974-75 and the slackness of the recovery that followed. This created an obstacle to the growth of exports from developing countries, especially where the weakness of external demand had the effect of depressing export prices. These difficulties were further aggravated by the wave of protectionism that accompanied and was stimulated by the economic slowdown in the industrial countries. The Multi-Fibre Arrangement expands the scope and increases the intensity of discriminatory restraints on shipments of textiles from developing to developed countries. Moreover, these restrictions affect supplies not only from the major exporters but also from the poorer countries (such as Bangladesh, Indonesia, and Sri Lanka) where textile products account for a high proportion of manufactured exports.(2) Quota restrictions have also been introduced or intensified in relation to other products of interest to exporters in developing countries in a broad spectrum ranging from petrochemicals to footwear to bicycle tires and tubes. Major barriers have also been applied increasingly to developing country exports of beef, sugar, vegetables, tobacco and grains, as well as manufactured food products of various types.(3)

Thus, while the international community often requires prompt adjustment in countries with balance of payments deficits, it tolerates increasingly restrictive trade measures that frustrate the efforts of the deficit countries to adjust. Similarly, while great emphasis is placed on exchange rate realignment as a means of correcting external imbalance by improving the export competitiveness of developing countries, the efficacy of the exchange rate weapon is continually eroded through the removal of products from the influence of the price mechanism and the forces of competition by direct control.

It is a fundamental conclusion of the present study that, in determining the appropriate volume of balance of payments support and the conditions required for the provision of that support (including the period over which adjustment should be programmed), it is important to distinguish between those elements of a balance of payments deficit for which a developing country is itself responsible and those elements that are due to factors beyond its control. This principle has already been accepted by the International Monetary Fund in the limited context of the compensatory financing facility and what is now proposed is an extension of that principle to all sources of disturbance in the balance of payments. Later paragraphs will suggest some of the ways in which this principle might be applied. Briefly, it would appear that to the extent that deficits are not due to excessive demand, but are the counterpart of structural surpluses elsewhere in the system, or reflect major price movements of external origin, adjustment should take place over extended time periods. On the other hand, to the extent that deficits are due to a shifting of balance of payments pressures from other countries owing to low levels of activity or import restrictions, remedial measures should be adopted by the latter countries as soon as possible; and in the meantime the counterpart deficits should be financed. The fact that the above-mentioned approaches were not adopted on a sufficient scale during the recent period of crisis, and that rapid adjustment was generally required regardless of the source of disequilibrium, meant that avoidable costs were incurred by many developing countries, particularly by the poorest among them.

THE IMPACT OF DISEQUILIBRIUM

The impact of disequilibrium on developing countries was profound, but it was also uneven. While virtually all non-oil-exporting countries suffered major setbacks at some stage as a result of external disturbances, often combined with domestic problems, some of them managed to surmount the difficulties with which they were confronted and to maintain or even increase both current rates of growth and rates of investment in future growth. Their ability to do so, however, frequently depended on recourse to the private capital market, and the recycling facilities that it provided, as well as on the low level of loan demand in the developed countries at the time. Moreover, the terms and conditions on which these resources were obtained did not always permit a satisfactory programming of debt service obligations over time. The resources of the official international financing agencies were entirely insufficient to provide more than a small proportion of

the borrowing facilities that were needed to sustain the deficit countries while adjustments were made.

A second characteristic of most of the more successful countries was that their capacity for adjustment was substantial because of the earlier progress that they had made towards diversification of the domestic economy in general and of the structure of exports in particular. The capacity for adjustment is far from uniform among countries. The elasticity of an economy, especially of its foreign trade sector, and the mobility of its resources and, hence, its capability for withstanding external shocks tend, on the whole, to be related to its level of development. There are marked differences in the ability of countries to raise export earnings, particularly by expanding exports of manufactures or of other nontraditional products such as processed foodstuffs. Similarly, countries differ considerably in the extent to which they can compress imports without suffering adverse effects. Much depends on the degree and promptness with which a country can shift resources from domestic consumption to exports and provide domestic substitutes for imports. This kind of mobility and flexibility is, in turn, a function of the stage of development attained and, in particular, of the size of the industrial sector. It is the relatively more developed countries that have the advantage in minimizing the costs and maximizing the benefits of the adjustment process. An equitable distribution of the burden of adjustment would take these factors into account, whereas, in practice, the burden has tended to weigh more heavily on the developing countries, and particularly upon the poorest among these countries. It was also the poorest countries that were least able to take advantage of borrowing facilities in private capital markets, as noted earlier.

Foreign exchange reserves were insufficient in most cases to absorb more than a quite limited proportion of the initial impact of the crisis; and the effect of the crisis period has been that the reserves of a number of countries have been reduced below levels that would provide even the barest minimum of operational flexibility for short-term economic management.

Once recourse to reserves and borrowing capacity had been exhausted, there was no way of avoiding reductions in economic activity and welfare. The evidence shows a tendency for growth rates and investment to decline markedly in the wake of the crisis; and, in many cases, there was serious disruption of development programs. In some countries, declines in real wages during the 1970s reached proportions as high as 20 to 40 percent, and the distribution of income probably suffered. Such declines would be unthinkable in the industrial countries. The economic dislocation and political and social tensions generated by shifts of such magnitudes raise

serious questions as to the compatibility of the short-run measures of adjustment to which countries felt compelled to resort with their long-run development objectives, as well as with the objectives of the international community under the International Development Strategy.

THE INTERNATIONAL ENVIRONMENT FOR ADJUSTMENT

It will be apparent from the foregoing that consideration of the problem of balance of payments adjustment cannot be separated from the wider context of trade and long-term capital flows. Improvement in the adjustment process calls for the creation of an international environment in which developing countries pursuing effective development programs would be able to rely on a steady expansion of export markets in the developed countries with reasonable stability of prices and absence of trade barriers, particularly of a discriminatory kind. Developed countries do, of course, have problems of their own in absorbing certain types of imports from developing countries, particularly at times of high unemployment, and legitimate requirements for easing the process of adjustment in the former countries should be recognized. But to the extent that the developed countries seek to ensure that their own adjustment to a higher level of imports from developing countries is programmed over an adequate period, so also is a corresponding stretching out of the counterpart process of adjustment in developing countries necessary and desirable. Similarly, an expansion of the flow of long-term capital through bilateral and multilateral channels should be regarded as an indispensable ingredient in improving the international environment for adjustment. Such expansion would make it possible for adjustment to take place at a higher level of economic activity than would otherwise prevail, and would facilitate the redeployment of resources needed to improve the flexibility and responsiveness of the economies of developing countries. In this context, particular interest attaches to the expansion of the resources of the World Bank and the regional development banks.

A proposal has been made by the Mexican government for a long-term facility for financing purchases of capital goods by developing countries. The proposal is envisaged as a "long-term recycling fund." It is designed to take advantage of the fact that given appropriate financing, surplus capacity in the capital goods industries of industrial countries could be utilized to meet the potential demand for capital goods in developing countries. Implemented in a manner that would be equitable between various groups of developing countries, it

could help to counteract the effects of low levels of activity in the industrial countries in shifting balance of payments pressures to developing countries.

FUND CONDITIONALITY AND THE ADEQUACY OF RESOURCES

Improvements in the general environment of international trade and capital flows along the lines suggested above would facilitate the task of the International Monetary Fund in carrying out the role envisaged for it in its Articles of Agreement. As matters stand, the contribution made by the Fund is a limited one. Recourse to IMF credit in recent years has been relatively modest. Moreover, such use of Fund credit as did occur was concentrated almost entirely on the facilities available on relatively easy conditions - the oil facility, the compensatory financing facility, and the reserve and first credit tranches. Drawings on the upper credit tranches of the Fund, subject to stringent conditions, were regarded as something to be avoided except as a last resort. Thus, the question is not merely whether the volume of international official resources for balance of payments support is adequate in the light of potential needs, but whether the resources that do exist are sufficiently "available" for the purposes intended.

It is largely for these reasons that the Fund finds itself in a paradoxical position in relation to the world economy. It might have been expected that at a time of relatively poor performance of the world economy, as described by the Fund itself in its Annual Report 1978, the Fund would be a net supplier of resources in support of the level of activity and employment. In fact, however, the Fund is currently receiving substantially larger repayments from past drawings than it is channelling afresh to countries in need of balance of payments support. (During 1978 repurchases exceeded drawings by SDR 1.1 billion; and repurchases by non-oil-exporting developing countries exceeded drawings by those countries by SDR 693 million.)

There is no disagreement among governments on the broad principle of conditionality in the Fund. The issue arises rather from the practical application of Fund policies relating to conditionality. There is a relationship between the willingness of countries to accept Fund conditions and the amount of resources that the Fund is able to make available to them. The size of these resources is, in turn, an important determinant of the conditions required. The larger the resources that can be provided, and the longer the period over which they can be made available, the less abrupt does the adjustment process have to be, and the easier the

conditions that can be applied. During the period covered by the present study, the severe limitation on borrowing facilities at the Fund in relation to the size of deficits made it inevitable that the terms and conditions of Fund loans were more exacting than they might otherwise have been, because it was necessary to close a relatively large gap in a relatively short period.

It has been suggested by the Managing Director of the Fund that the severity of Fund conditions has often reflected the failure of countries to approach the Fund at a sufficiently early stage in the evolution of a problem.⁽⁴⁾ This in turn, however, was due to a vicious circle in which countries were reluctant to draw on the upper credit tranches of the Fund except as a last resort, because of the exacting conditions that they expected to be imposed; while the Fund acquired a reputation for severity precisely because countries turned to it only when everything else had failed.

The low degree of utilization of the upper credit tranches of the Fund suggests that the conditions required for drawings in these tranches have become too demanding in relation to the amount of resources made available. It appears, in fact, that the point has been reached at which the rigors of conditionality have begun to reduce the effectiveness of the Fund's cooperation with member countries, by preventing them from approaching the Fund except in the most extreme circumstances. Both for this reason, and on the merits of the case, an easing of conditions seems justified.

THE NEED FOR LONGER-TERM MEASURES OF ADJUSTMENT

The problems arising during the period of adjustment covered by the present study were not merely problems of demand management in the short term. Major structural changes were required, while the time horizon of the Fund's operations was much too short to provide adequate support for longer-term measures of adjustment. In many cases disequilibrium in the balance of payments may result from a lack of elasticity in the economy - for example a rigidity in the supply of food or other basic consumption goods, or an inability to shift resources readily in line with new market requirements. In establishing an oil facility at low conditionality, the Fund recognized that a new source of medium-term financing was required to give countries time to make the structural adjustments needed to realize economies in the use of energy. But the oil case is not unique. It is only one example of a whole series of cases in which effective steps to deal with pressures on the balance of payments may need to include

measures to tackle basic causes of disequilibrium over a period substantially longer than that of the traditional stabilization program.

The fundamental case for longer-term financing by the Fund has already been accepted in principle by the Fund membership in connection with the establishment of the Extended Fund Facility. Two types of situation were envisaged in which such financing might be required. The first related to cases where the economy had suffered from serious imbalances over a number of years, and price and cost distortions had become widespread. It was recognized that the time needed for generating new or expanded production and achieving significant gains in productivity would make a strong case for longer-term Fund financing. A second type of situation involved countries with a very narrow productive base and high dependence on a few export commodities. Such countries were considered to have inherently weak balance of payments positions that would deteriorate quickly if development efforts were stepped up. Moreover, growth was likely to be hampered from time to time by the emergence of bottlenecks in important areas of production. While situations of this type called for long-term development assistance on terms such as those offered by IDA, it was recognized that there was room for support of the kind that the Fund could provide.

It was pointed out at the time that situations of the latter type raised important questions regarding the appropriate division between project aid and balance of payments assistance, and the appropriate sharing of responsibility between the Fund and the development financing institutions. The Fund has, in fact, worked in close collaboration with the World Bank in a number of situations involving use of the Extended Fund Facility, and an example of such collaboration in the case of Kenya is discussed in chapter 2. The intimate relationship between the activities of the two institutions is reflected, among other things, in the fact that program loans of the World Bank are intended to help countries to overcome temporary difficulties that would otherwise result in inappropriate long-term adjustments designed to correct short-term balance of payments disequilibrium.

What is now suggested is a further extension of a principle that has already been accepted. While the Extended Fund Facility took the first step in reducing the distance between the short-term balance of payments approach of the Fund and the long-term development approach of the World Bank, there remains a substantial gap between the two approaches involving the medium term. It has become clear in the course of the 1970s that for developing countries the process of adaptation to external shocks to the balance of payments of the magnitude experienced during this period calls

for efforts of adjustment that go well beyond the time frame and scope envisaged even under the Extended Fund Facility. No doubt, as the period of adjustment is lengthened, and the scope of measures required expands, it becomes difficult to distinguish between the adjustment process and the development process. The two activities reach a point at which they may be said to merge.

Yet, even in the short term, effective management of the balance of payments is closely bound up with the long-run development process. On the one hand, development is obstructed if disequilibrium in the balance of payments is not overcome; and on the other, balance of payments adjustment is facilitated the higher the level of economic activity and development effort that accompanies it.

The problems of adjustment and development are, therefore, a continuum, and the stratification of institutions should not prevent related problems from being dealt with in a related manner. The cooperation established between the Fund and the World Bank, which has already made important progress along these lines, should be strengthened further. The proposal made below for expansion of the responsibilities of the Fund is not intended to encroach in any way upon the area of responsibility of the World Bank, any more than the program lending of the World Bank in the circumstances defined earlier is intended to interfere with the responsibilities of the Fund. The intention of the proposal is, rather, to ensure that cases of balance of payments adjustment requiring medium-term financing do not fall between two stools.

THE NEED FOR SYMMETRY IN THE ADJUSTMENT PROCESS

The severity and abruptness of the adjustment required of many developing countries imply a marked asymmetry as compared with the rate of adjustment taking place in the surplus countries. The government of the Federal Republic of Germany has described the German surplus as being "structural" in character, so that the adjustment process must "take time and organizational imagination."⁽⁵⁾ But if the international community accepts the idea that adjustment of structural surpluses downwards will have to be programmed over an extended period, it cannot escape the consequences that this has for the counterpart deficit countries. Indeed, the inevitable outcome of forcing excessive retrenchment on deficit countries while surplus countries continue to maintain their surpluses is that the deficits are simply shifted from country to country. And the cumulative deflation thus brought about by the adjustment process is thereby super-

imposed on, and reinforces, the primary deflation resulting from business slowdown in the industrial countries. There is, however, no reason why surplus countries should not stretch out their own adjustment process provided that they are prepared to finance their surpluses at long term and ensure sufficient recycling through international agencies to the countries faced with the counterpart deficits.

By the same token, the case for avoiding hasty exchange rate changes in the surplus countries is equally applicable to the deficit countries, to the extent that their deficits are the counterpart of structural surpluses elsewhere in the system.

The surplus positions of certain of the oil-exporting countries involve some additional considerations. In particular, to the extent that they are called upon to supply oil to the world economy in excess of their current requirements for imports, it is natural that they should seek to acquire counterpart assets of their choice. Here too, however, it is necessary to avoid consequential pressures on the balances of payments of other countries, especially the poorer and weaker countries, and hence to recycle a sufficient volume of resources to the counterpart deficit countries.

RECOMMENDATIONS

The foregoing discussion has set out some of the principal considerations emerging from this study of the balance of payments adjustment process in the developing countries in the 1970s; the following recommendations respond to these considerations.

Improvement of the adjustment process in developing countries requires the creation of an international environment conducive to this end. Such an environment implies attainment of the highest possible level and rate of growth of economic activity and import demand in the industrial countries, and the phasing out of obstacles to exports of developing countries. The sensitivity of commodity prices to even minor declines in import demand in the industrial countries, and the growing wave of protectionist measures restricting industrial country imports from the developing countries exert downward pressure on the exports of the latter countries. This, in turn, means that the burden of adjustment falls upon the imports of developing countries to a greater extent that would otherwise be required. The international community should recognize the importance of commodity price stabilization and developing country access to markets not only in creating equitable conditions for world trade but also in facilitating the adjustment process. By the same token, the success of programs of adjustment requires substantially larger flows of long-term capital through bilateral channels as well as through the World Bank and regional development banks to facilitate

the long-term structural changes that would increase the capacity of the developing countries to adjust to disequilibrium, whether of domestic or external origin. In this context, a proposal has been made by the Mexican Government for a long-term facility for financing purchases of capital goods by developing countries.

The strengthening of cooperation between the Fund and developing member countries requires that the principle of conditionality be applied in as flexible and responsive a manner as possible to encourage greater recourse to the Fund's facilities and a much higher rate of utilization of its resources, including the resources in the upper credit tranches. The conditions for drawings in the upper tranches as well as under the Extended Fund Facility and Supplementary Financing Facility should permit deficit countries to phase the adjustment process over longer periods, to undertake the structural changes required to achieve balance of payments equilibrium, and to avoid the disruption of development programs. In this context, the Ministers of the Group of Twenty-four, at their seventeenth meeting, expressed concern at the multiplicity of performance criteria and some other forms of conditionality that inhibit access to Fund resources by member countries. They urged the Executive Board of the IMF to set appropriate guidelines and establish other institutional procedures related to the use of Fund resources, especially in the upper credit tranches, in support of economic adjustment programs. They were of the view that the guidelines should be designed to limit the performance criteria only to relevant macroeconomic variables, paying due regard to the growth considerations of member countries, and their prevailing economic and social situations. (6)

Greater use should be made of the Extended Fund Facility as well as of associated program lending by the World Bank. It should be recognized that, in particular cases, support for balance of payments adjustment may be programmed over time periods significantly longer than those presently envisaged under the Extended Fund Facility.

An effort should be made by the Fund in cooperation with the member country concerned to determine the broad extent to which a potential or actual balance of payments deficit is due to factors within the responsibility of the country concerned as against factors beyond its control, including structural or persistent surpluses in the balances of payments of other countries. This distinction should be taken into account in determining the magnitude of adjustment and amount of balance of payments support required, and the measures and policies to be adopted as a condition for drawings on the Fund.

The adjustment process should be placed firmly in the broader context of long-run development. Negotiations

between member countries and the Fund as to the adjustment measures and policies required in connection with standby arrangements, whether for one year or longer, should explicitly address the question of ensuring consistency between short-run and long-run objectives. Likewise, the standby arrangements presented for the consideration of the Executive Board of the Fund should indicate the manner in which such consistency is ensured under the arrangements proposed, including the means whereby the Fund as well as other national and international sources of finance will assist the country in minimizing the disruption of development programs.

Any significant lengthening of the period of adjustment, and consequential easing of the conditions of stabilization programs, is likely to eliminate the present underutilization of resources and bring the Fund up against the problem of resource constraints. Steps should therefore be taken to enhance the capacity of the Fund to play the role envisaged for it in the Articles of Agreement by increasing its lending capacity in relation to world trade. A variety of options could be envisaged for this purpose. One such option is that, at the end of the initial two-year period, the Supplementary Financing Facility should be made permanent together with the financing required for that purpose. At the same time, the conditions for drawing on the facility should be eased, as in the case of the oil facility, and the maximum period for repayment should be extended.

An alternative approach would be to bridge the gap between the international facilities presently available for balance of payments support on the one hand and for financing long-term development on the other. To this end, a medium-term facility should be established at a substantial level of resources to provide balance of payments support over periods of 5 to 10 years. The funds for such a facility could be raised in capital markets along the lines employed by the World Bank. One advantage of this approach is that it would give the Fund the capacity for a greater degree of initiative in carrying out its recycling role. This advantage would appear to outweigh the disadvantage of the higher cost of Fund borrowing from member governments indirectly through private capital markets rather than directly. The terms and conditions of loans should be adjusted to the circumstances of borrowing countries, and since commercial terms would be inappropriate for the poorest countries, it is a condition for the viability of this proposal that provision should be made for interest subsidies to the countries already eligible for such subsidies under the Fund's oil facility. The facility should be located within the framework of the Fund.

Surplus countries that wish to program the adjustment of their balances of payments over extended periods have a special responsibility for channeling resources to the Fund,

World Bank, and other international lending agencies to ensure a recycling of resources that will be equitable between those countries that do and those countries that do not have access to other sources of funds, including private capital markets.

In the longer run, it should be an objective of the Fund that the ratio of Fund quotas to the imports of members should regain the level of the 1950s, that is, a level of 10 percent.

Where the resources available in a member's reserve tranche and first credit tranche fall short of the amount of balance of payments support needed in the light of pressures on its balance of payments due to circumstances beyond its control, first credit tranche conditionality should be applied to the financing required in the subsequent tranches. (The principle that balance of payments difficulties resulting from factors beyond the control of a country may justify lower conditionality financial assistance to that country has already been recognized in the Compensatory Financing Facility of the Fund, designed to deal with cases involving export shortfalls.)

Where a member country decides to apply to the Fund for balance of payments support at an "early stage" of a balance of payments problem (see IMF Managing Director's statement of May 22, 1978, IMF Survey, p. 149), first credit tranche conditionality should be applied to cover the entire amount of the drawing required. The determination of the meaning of "early stage" might take into account the level and rate of increase of the balance of payments deficit.

Consideration should be given to additional issues of SDRs over and above those presently contemplated, with a view to strengthening the capacities of member countries for short-term balance of payments management as well as contributing towards making SDRs the principal reserve asset in the international monetary system.

Where, despite the measures suggested above, pressure on the balance of payments of a developing member country builds up due, in part, to factors beyond its control, and further adjustment becomes unavoidable, it should be recognized that there may be a need for the imposition of import restrictions by the government in the context of a satisfactory program of adjustment agreed with the Fund, if such measures are required to avert or mitigate a decline in real per capita output or income.

An effort should be made to improve the understanding of governments, scholars, and the public generally of the methods of operation of the IMF and the methodologies employed as a basis for its negotiations with member governments. To this end, the Fund should consider publishing as detailed an account as possible of the methodologies employed in practice in analyzing the balance of payments of member countries, in distinguishing between various sources of balance of payments pressure, in

determining performance criteria and other adjustment measures, in monitoring the performance of countries under standby arrangements, and in reviewing the continuing validity of the content of such programs.

Appendix — Origins of the Principle of Conditionality

There is no disagreement among governments on the broad principle of conditionality in the Fund. All governments recognize that drawings in the upper tranches should be subject to agreement between the Fund and the member governments concerned as to the achievement of a viable balance of payments position in the medium term.

It is, nevertheless, interesting to recall that this was not always the case. Most of the governments that adhered to the original Articles of Agreement of the Fund, with the notable exception of the United States, did so under the impression that conditions for drawings on the Fund would be limited to those set out in the Articles of Agreement. A member's own declaration that it needed a particular currency for making payments in a manner consistent with the provisions of the Agreement would, in the view of most governments, be sufficient to enable it to draw against the Fund's holdings of that currency, without challenge. There was certainly no requirement in the Agreement that a member seeking such a drawing should reach an understanding with the Fund on the economic policies that it should pursue. The Fund could limit drawings by a member only if that member was found to be using Fund resources "in a manner contrary to the purposes of the Fund."⁽¹⁾

"Unencumbered access" to Fund resources was considered to be fundamental in giving members the confidence they needed to reintroduce an open system of international trade and payments and progressively liberalize the restrictions that had been placed upon them. According to Professor Richard N. Gardner, "The British Government believed that Fund members could dismantle their economic defences only if given unencumbered access to Fund resources. Drawing rights could not be made dependent on Fund approval of a member's

economic policies without violating this principle."(2) The United States Government, on the other hand, considered that a country's right to assistance from the Fund was contingent upon its adoption of policies in harmony with the purposes of the Fund.(3) The Fund History refers to the "principle of automaticity" that, in the view of many members, should govern the system of drawing rights established at Bretton Woods; and to the fact that "for a short time in 1947 it became the practice for a member to be allowed to draw without the Board's specific approval sums not exceeding 5 percent of its quota in any thirty days."(4) In May 1947, however, the Executive Board adopted a decision clarifying the meaning of Article V Section 3 (a) (i). A member would be deemed to have satisfied the condition for drawing contained in that subparagraph if it declared that the currency to be drawn was presently needed for making payments in that currency which were consistent with the provisions of the Agreement. But the Fund could challenge the correctness of the declaration "for good reasons," including consistency with the Agreement. Although this decision did not, as yet, amount to a requirement that a member seeking to draw on the Fund reach agreement with the Fund on corrective measures to be adopted, it did strike hard at the principle of automaticity.

The explanation given in the Fund History for the ultimate abandonment of the principle of automaticity is the ineffectiveness of the Articles of Agreement in ensuring the repayment of drawings (repurchase of currency). The reason given for this is that under Article V Section 7 (c) (i) there was no obligation on a member to repurchase its currency to the point at which its monetary reserves would fall below its quota.(5) In the early postwar years, many members' reserves were already below their quotas; the United Kingdom and other sterling area countries were among those in this situation. Since the sterling balances were, at the time, inconvertible, they were not included in reserves for the purposes of Article V Section 7 (c) (i). The Fund History points out further that "The Board also realized that the size of a member's monetary reserves was to a considerable extent within its own power to determine and, accordingly, if a member wished to avoid a repurchase obligation, it had a fairly ready method of doing so."(6)

In view of the emphasis placed on the above points as the key issues at the time, it is interesting to speculate what the fate of the principle of automaticity might have been in the event that repurchase obligations had been defined more precisely in the original Articles of Agreement, and the escape clause contained in Section 7 (c) of Article V (regarding the level of reserves in relation to quota) had taken the form of a waiver of the ordinary rule, requiring approval by the Fund. It is by no means certain, of course, that such provisions

would have sufficed to save the principle of automaticity. Certainly, the voting power of the delegations (including the United States) that regarded the principle of conditionality as fundamental was sufficient to prevail sooner or later. What is more debatable is whether a Fund based on the principle of automaticity could have functioned in a manner that would have ensured repayment of drawings. It should be borne in mind that the Agreement did contain, in Article V Section 5, provision for the Fund to limit drawings by a member "using its resources in a manner contrary to the purposes of the Fund" and ultimately to declare the member ineligible to use the Fund's resources. If "automatic" access to Fund resources had been maintained, it would certainly have become necessary to develop a set of principles and procedures for the application of the above-mentioned safeguards. But it is arguable that this could have been done without requiring as far-reaching an involvement of the Fund in the affairs of certain of its members as developed subsequently.

EVOLUTION OF THE PRINCIPLE OF CONDITIONALITY

Partly because of the "ERP decision" limiting drawings on the Fund by countries receiving resources from the European Recovery Program,(7) but partly also because of the above-mentioned concerns regarding the repayment of drawings, the use made of the Fund's resources remained for some time at a relatively low level. The dilemma facing the Fund was reflected in the fact that while total drawings from the beginning of operations through April 30, 1951, exceeded \$800 million, including \$400 million by the United Kingdom and India, repurchase obligations during the five years ending April 30, 1952, amounted to only \$190 million (none of this being due from sterling area countries).(8)

The issue of how to reconcile assurance of access to Fund resources with corresponding assurance that drawings would be repaid in good time was the subject of prolonged discussion at meetings of the Executive Board and of the Board of Governors of the Fund. The discussions culminated in a landmark decision of the Executive Board, known as the "Rooth Plan," adopted on February 13, 1952. Among the main points of this decision, which represents a further stage in the substitution of the principle of conditionality for that of automaticity, were that:

1. drawings should be for periods "within an outside range of three to five years";
2. the Fund would agree with a member on arrangements to ensure repurchase as soon as

- possible, within a maximum period of five years;
3. a member seeking to draw from the Fund "will be expected to include in its authenticated request a statement that it will comply" with the principles of this decision;
 4. these principles would be an essential element in any determination by the Fund as to whether the member was using the resources of the Fund in accordance with the purposes of the Fund; and
 5. a "member can count on receiving the overwhelming benefit of any doubt" respecting drawings in the gold tranche.(9)

In 1955, the policy of differentiating between drawings in the successive credit tranches was embodied in the further principle that "the larger the drawing in relation to a member's quota the stronger is the justification required of the member," but it was noted that in practice, policy towards drawings in the first credit tranche would be "liberal."(10)

In the Fund's Annual Report 1959, the following classic statement of policy was made:

Members are given the overwhelming benefit of the doubt in relation to requests for transactions within the 'gold tranche'.... the Fund's attitude to requests for transactions within the first credit tranche ... is a liberal one, provided that the member itself is also making reasonable efforts to solve its problems. Requests for transactions beyond these limits require substantial justification. They are likely to be favorably received when the drawings or stand-bys are intended to support a sound program aimed at establishing or maintaining the enduring stability of the member's currency at a realistic rate of exchange.(11)

Despite the virtual automaticity of drawings in the gold tranche, it was recognized that the use of that tranche, and even of the super gold tranche, remained juridically and, therefore, potentially in fact, conditional. They, therefore, could not be included in reserves on the same footing as gold or convertible currencies.(12) Accordingly a change was made in the Articles of Agreement in 1969 which rendered gold tranche drawings legally immune from challenge.(13)

Standby arrangements had been foreshadowed in the Rooth Plan, which had provided for discussions between a member and the Fund "not with a view to any immediate drawing, but in order to ensure that it would be able to draw if, within a

period of say 6 or 12 months, the need presented itself." (14) The essential characteristic of a standby arrangement is that a member is given the assurance that it will be able to use the Fund's resources without any further review of its position and policies. (15)

The concept of standby arrangements has undergone what the Fund's General Counsel has referred to as "a complete metamorphosis" since it was first introduced. As he points out:

Originally it was considered as something in the nature of a confirmed line of credit that gave a member an absolute right to make purchases subject only to those provisions of the Articles on ineligibility and the general suspension of operations that were lex cogens and therefore necessarily applicable. At the present date it has become the main instrument for conditionality, and, in particular, for making the Fund's resources available beyond the first credit tranche only if the member observes certain policies. Annexed to each standby arrangement is a letter of intent from the member's authorities in which they set forth the program they will pursue. The standby arrangements that permit purchases beyond the first credit tranche include performance clauses establishing criteria on the nonobservance of which the member's right to make purchases under the standby arrangement will be interrupted without the need for a decision by, or even notice to, the Executive Directors. Performance criteria are invariably objective in character, in the sense that a subjective judgment is not necessary in order to ascertain whether they are being observed, with the result that a member will know at all times whether it is able to make purchases. The movement, therefore, has been from the assurance of use without the review of requests to the definition of the circumstances in which there is assured use without review. (16)

The General Counsel indicates further that one of the reasons why the standby arrangement was transformed into an instrument of conditionality was to enable members to make a large outstanding use of the Fund's resources in terms of quota, having regard to the fact "that quotas are less than they might be." (17)

A comprehensive decision on standby arrangements adopted in September 1968 has, with minor modifications, provided the basis for Fund policy since that time. The main elements of the decision were that:

1. Clauses requiring the member to remain in consultation with the Fund were to be included in all stand-by arrangements; periodic consultations were also to be required in all cases of drawings beyond the first credit tranche, whether under a stand-by arrangement or otherwise.
2. No provision would be required for phasing of amounts drawn, and achievement of performance criteria as a condition of each additional drawing, in standby arrangements limited to the first credit tranche. Such provisions would, however, "normally be included" in all other standby arrangements, but would be applicable only to purchases beyond the first credit tranche.
3. In exceptional cases, phasing would not be stipulated if it were essential that the full amount of the standby arrangement should be available promptly.
4. Performance clauses would be limited to stipulating criteria necessary to evaluate the implementation of a member's stabilization program.(18)

Notes

CHAPTER 1

1. For an account of the recession, see Organization for Economic Cooperation and Development, "The Origins of Present Problems," Towards Full Employment and Price Stability (Paris, 1977), Chapter I.
2. Ibid., p. 45.
3. The "primary factor" in a deterioration in a country's trade balance was defined either as a movement in prices or quantities that, taken by itself, was sufficient in magnitude to produce a deterioration of the size observed; or as the most important single negative factor operating on the trade account, provided that its quantitative importance was at least twice that of the next most important single negative factor. In cases in which neither of these criteria was met, the observation appears in table 1.6 under item 3e, "not assigned."

CHAPTER 2

1. On this and subsequent points made, see tables 2.14 to 2.26.
2. See J.P.R. Velloso, Brasil: A Solucao Positiva (Sao Paulo: Abril-Tec Editoria), p. 115.
3. Statement by the Minister of Finance and Planning at the Annual Meetings of the IMF and IBRD, September 27, 1978.
4. For further details see Edmar L. Bacha, "Notes on the Brazilian Experience with Minidevaluations: 1968-1976,"

- paper presented to a Ford Foundation/Central Bank of Barbados Seminar held in Bridgetown, Barbados, January 11-14, 1978.
5. See IMF, The Rise in Protectionism (Washington, D.C., 1978), p. 58.
 6. More formally, let $Y = E + P_x X - P_m M$, where Y = real income, E = real domestic expenditure, P_x and P_m the prices of exports and imports, and X and M the export and import quantums. Then, with fixed E , X and M : $dY = X dp_x - M dP_m$ or $dY/Y = - (P_m M/Y) (dP_m/P_m - a dP_x/P_x)$, where $a = P_x X/P_m M$.
 7. Rattan J. Bhatia and Saul L. Rothman, "Introducing the Extended Fund Facility: the Kenyan Case," Finance and Development (December 1975).
 8. Sessional Paper No. 4 of 1975: On Economic Prospects and Policies.

CHAPTER 3

1. Articles of Agreement of the International Monetary Fund (Washington, D.C., 1978), Article VII, Section 3. (Referred to hereinafter as Articles of Agreement.)
2. International Monetary Fund, Annual Report 1978, Washington, D.C., 1978, p. 1.
3. International Monetary Fund, Annual Report 1974, Washington, D.C., 1974, p. 26.
4. Ibid., p. 27.
5. Annual Report 1978, pp. 18-20.
6. Deena Khatkhate and Delano P. Villanueva, "Operation of Selective Credit Policies in Less Developed Countries," World Development, 6, nos. 7/8 (July/August 1978): p. 980.
7. International Monetary Fund 1966-71, Vol. I (Washington, D.C., 1976), pp. 364-68. (Referred to hereinafter as Fund History 1966-71.)
8. IMF, The Monetary Approach to the Balance of Payments (Washington, D.C., 1977).
9. Fund History 1966-71, Vol. I, p. 368.
10. Carl P. Blackwell, "Reflections on the Monetary Approach to the Balance of Payments," IMF Survey, February 20 and March 6, 1978.
11. J. Marcus Fleming and Lorette Boissonneault, "Money Supply and Imports," The Monetary Approach to the Balance of Payments, p. 145.
12. Ibid.

13. Yung Chul Park, "The Variability of Velocity: An International Comparison," IMF Staff Papers, November 1970.
14. The International Monetary Fund 1945-1965, Vol. II (Washington, D.C., 1969), p. 533. (Referred to hereinafter as Fund History 1945-65.)
15. Ibid.
16. Joseph Gold, The Standby Arrangements of the International Monetary Fund (Washington, D.C.: International Monetary Fund, 1970), p. 57.
17. Ibid., p. 191.
18. Carl P. Blackwell, op. cit.
19. Bank of England, Quarterly Bulletin, 18, no. 1 (March 1978): 36.
20. Ibid., p. 37.
21. See "A Profile of 1967-76: Role Played by Resources of Fund in Financing Payments Needs," IMF Survey, June 5, 1978.
22. IMF Survey, May 22, 1978, p. 149.
23. Intergovernmental Group of Twenty-four on International Monetary Affairs, Communique of the Seventeenth Meeting of Ministers, September 22, 1978, para. 12. IMF Survey, October 2, 1978.
24. GATT, International Trade, 1976/77 (Geneva, 1977), p. 22.
25. Articles of Agreement, Article I(ii). (Emphasis supplied.)
26. Andrew D. Crockett and Saleh M. Nsouli, "Exchange Rate Policies for Developing Countries," Journal of Development Studies, 13, no. 2 (January 1977).
27. IMF Survey, May 22, 1978, p. 147.
28. H. O. Ruding, "The IMF and International Credit," The Banker (London) June 1978, p. 30.
29. In the course of testimony before the United States House of Representatives Committee on Banking and Currency on March 21, 1945, W. Randolph Burgess, President of the American Bankers' Association, presented the Association's view "that the objectives of Bretton Woods could be carried out best if there were but one international financial organization instead of two. We think that one organization could carry out the objectives more efficiently, in a more orderly way, and more economically than could two.... Rules regarding international exchange restrictions, parities and other such questions can be worked out through the stabilization department of the bank more effectively than if such questions were relegated to an institution which had no responsibility with respect to long-term loans. Some stabilization programs will call for long-term loans." (Emphasis supplied.)

CHAPTER 4

1. IMF, Annual Report 1974, p. 26.
2. World Bank, World Development Report 1978 (Washington, D.C., August 1978), pp. 15 and 18.
3. Ibid.
4. IMF Survey, May 22, 1978, p. 149.
5. Address by the Minister of Finance of the Federal Republic of Germany to the Annual Meetings of the IMF and World Bank on September 25, 1978.
6. Intergovernmental Group of Twenty-four, Communiqué of the Seventeenth Meeting of Ministers, September 22, 1978. IMF Survey, October 2, 1978.

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2. Richard N. Gardner, Sterling-Dollar Diplomacy (New York: 1969), p. 262.
3. United States Treasury, Questions and Answers on the Fund and Bank (Washington, D.C., 1945), p. 8.
4. Fund History 1945-65, Vol. II, p. 391.
5. Ibid.
6. Ibid.
7. Ibid., pp. 394-97.
8. Ibid., Vol. I, p. 277.
9. Ibid., p. 324.
10. Ibid., Vol. II, p. 404.
11. Ibid.
12. Ibid., pp. 405-06.
13. Ibid.
14. Ibid., p. 402.
15. Ibid., pp. 532-33.
16. Ibid., p. 533.
17. Ibid.
18. Fund History 1966-71, Vol. I, p. 347.

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IMPLICATIONS FOR DEVELOPING COUNTRIES OF CURRENT PROPOSALS FOR A SUBSTITUTION ACCOUNT

V.B. Kadam*

Introduction

1. The following paper has been prepared at the request of the Bureau of the Intergovernmental Group of Twenty-four on International Monetary Affairs. The proposals that the Bureau wished to have examined are, of course, not static. They have already been modified in certain respects in the course of negotiations, and further changes are to be expected as the negotiations continue. An effort has therefore been made to concentrate on the more fundamental issues involved, so that the discussion may be found useful even in the context of additional changes.

2. The objective of the paper is to contribute to the dialogue that is taking place by reviewing the main questions that involve essential developing country interests. It is hoped that this will be of assistance to the Group of Twenty-four and to the International Monetary Fund as a whole in devising an approach to the problem of a substitution account that would take these interests fully into account.

3. One of the main questions arising in this regard is how far it is possible to separate the establishment of a substitution account from the wider context of international monetary reform of which it is only a part. One view is that the establishment of a substitution account would be in itself a concrete and significant step towards longer range goals of reform. An alternative view, as advanced in the present paper, is that a substitution account can contribute towards reform only if it has certain characteristics, and is accompanied by certain complementary measures; and that failing this, there is reason for concern regarding the impact that the establishment of such an account might have, especially on developing countries. Whichever view is ultimately adopted by the Fund, it is hoped that the considerations adduced in the present paper will facilitate the designing of the substitution mechanism.

Origins of the Concept

4. A substitution account is a device for changing the asset composition of official reserves through conversion of reserves held in currencies into assets denominated in SDRs.

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5. In the 1972-74 discussions in the Committee of Governors of the International Monetary Fund on Reform of the International Monetary System and Related Issues (the Committee of Twenty), it was considered necessary to have a substitution facility to deal with the overhang of the existing reserve currency balances in the context of the asset settlement required under a par value system to promote timely and effective adjustment action by member countries. A return to the par value system was not considered by the Committee of Twenty to be feasible or even desirable in 1974 in view of the then increasing uncertainties affecting the world economic outlook. The Second Amendment to the Articles of Agreement of the International Monetary Fund adopted following the report of the Committee of Twenty accordingly dispensed with the obligation of a member to establish a par value for its currency by dropping all the provisions on par values of currencies under the old Article IV. Though the new Article IV permits "the introduction of a widespread system of exchange arrangements based on stable but adjustable par values," under Section 4, Section 2 of the same Article provides at the same time that "the Fund, by an eighty-five per cent majority of the total voting power, may make provision for general exchange arrangements" but only "without limiting the right of members to have exchange arrangements of their choice...". A par value system has thus been formally abandoned and major world currencies have continued to float on the exchanges. Under widespread floating, a substitution facility did not seem necessary as exchange rate variations were expected to ensure that all currency balances would be desired holdings, even as these variations promoted external adjustment while providing greater freedom for domestic economic management policies.

6. In the event, the flexible rate system is not seen to have brought about during the past six years of generalized floating the expected improvement in the field of balance-of-payments adjustment. It is also being increasingly recognized that floating rates do not permit domestic economic policies to be pursued in isolation from external influences. In the wake of large continuing payments imbalances and given the reluctance of the issuers of particularly strong currencies to see a major increase in the reserve role of their currencies, the expansion in the internationally held dollar balances has continued apace giving rise to exchange market disturbances from time to time. Exchange rate variations are seen not to have reflected correctly underlying movements in the balance-of-payments positions of individual economies. In these circumstances, Mr. H. Johannes Witteveen, the former Managing Director of the International Monetary Fund, revived the idea of a substitution account to convert what were viewed as excessive currency balances into SDR-denominated assets which would permit diversification of official reserves without the generation of additional exchange rate instability.

Perspectives for Present Proposals for a Substitution Account

7. A somewhat different and wider perspective is claimed for the proposals currently being discussed in the International Monetary Fund for an SDR-based Substitution Account. It is considered that such an

Account could constitute a major move toward a number of objectives of the reform exercise as defined in the early seventies, such as giving the SDR a primary and, ultimately, a dominant position among reserve assets; and promoting greater symmetry in the position of all countries in the adjustment process. It is suggested that in recent months there have been important shifts in circumstances and attitudes, to the point at which there is now a general sentiment that a reserve system depending overwhelmingly on the U.S. dollar is not desirable for the world as a whole or for the United States. At the same time, there is no desire to see the dollar system succeeded by a full-fledged multiple reserve currency system. Against the background of (i) the coming into force on 1 April 1978 of the Second Amendment to the Articles of Agreement of the International Monetary Fund which included inter alia the acceptance by members of the objective of making the special drawing right the principal reserve asset of the international monetary system, and (ii) the resumption of SDR allocations through a distribution of SDR 4 billion a year from 1979 through 1981 agreed upon at the September 1978 meeting of the Interim Committee in order to keep the SDR alive as an asset, these shifts are considered to point toward a renewed interest in aspects of reform that had been considered significant a decade ago.

Possible Forms of a Substitution Account considered in March 1979

8. In their report to the Interim Committee at its March 1979 meeting, 1/ the Executive Directors listed the following three possible forms of a Substitution Account:

- A. SDR-denominated claims issued by the United States: The simplest to introduce, this option involves a smaller exchange risk to the United States than in the case of the securities denominated in the deutsche mark, the yen and the Swiss franc that the United States decided on 1 November 1978 to issue in foreign markets up to an amount of \$10 billion, partly because the U.S. dollar makes up about a third of the SDR and partly because currencies likely to be weaker than the deutsche mark, the yen, and the Swiss franc also make up an important part of the SDR.
- B. Allocations of SDRs by the Fund: An SDR allocation would be made for an amount equivalent to the aggregate dollar balances to be substituted, each participant in the Fund's Special Drawing Rights Department depositing dollars with the Department equal in value to the participant's SDR allocation. Since allocations of SDRs by the Fund must be made to participants in proportion to their quotas in the Fund, this form would involve countries which did not already hold dollars, over and above their individual normal working requirements, in amounts adequate to deposit with the Special Drawing Rights Department against their SDR allocations - and their number as also the amount involved would not be insignificant - having to acquire the necessary dollars. It was envisaged that this might give rise to difficulties.

Moreover, it was pointed out that countries obviously differed greatly in the extent to which they were interested in the substitution exercise.

C. SDR-denominated claims issued through an account administered by the Fund: Members would deposit dollars in the account in amounts they individually desired to convert into SDR-denominated claims on the account against the dollar deposits. The account, which would invest the dollar deposits received by it in long-term obligations of the United States, would only be administered by the Fund and the Fund's resources would not be available to meet any of its liabilities. It is recognized that though the normal interaction of exchange and money markets should tend to keep, over the long run, the account's assets equal to or in excess of the SDR value of its liabilities, it would not be satisfactory to rely on this by itself. The relationship between the rate of interest earned by the account on the dollar balances held by it and the rate of interest paid by it on its SDR-denominated liabilities would be an important element in the financial strength of the account.

The Executive Directors reported that (i) there was broad support among them for consideration of a substitution account, although there were a number of reservations, "including the question of whether benefits of such a scheme would be achieved in absence of accompanying measures to control international liquidity"; (ii) "one important aspect of such a scheme to be studied further was its possible effects on the discipline of the international adjustment process over both deficit and surplus countries, which should not be weakened"; and (iii) most Directors favoured further consideration focusing on Option C, while there was some support for not ruling out Options A and B or combinations of Options.

9. Active consideration of a Fund-administered account, which would accept deposits of foreign exchange from members of the Fund on a voluntary basis in exchange for an equivalent amount of SDR-denominated claims, received broad support in the Interim Committee at its meeting on 7 March 1979. The communiqué released after the meeting also stated that "The purpose of such an Account would be to take a further step toward making the SDR the principal reserve asset in the international monetary system"; and that the Executive Board had been asked to present its conclusions to the next meeting of the Committee.

A Substitution Account issuing SDR-denominated Claims: Present Proposals

10. Accordingly, active consideration of a Substitution Account is in progress in the Executive Board. To promote the SDR as a principal reserve asset and to reduce the dominant role of the U.S. dollar in the reserve system (the dominance of national currencies in the reserve system permits significant asymmetry in the adjustment process), it is

clearly desirable that the scale of substitution should be large, and that the substitution arrangements should be so devised as to make the substitution permanent in principle. Secondly, since it is agreed that participation in the substitution arrangement should be on a voluntary basis, the arrangements should provide a reasonable balance of costs and benefits to reserve currency holders between holding currency balances and substituting them, as also an equitable distribution of costs and benefits both among those substituting their currency holdings, and as between the substituters of currency balances and the issuers of the currencies concerned. With claims on the United States and other claims denominated in U.S. dollars accounting for about 80 per cent of identified official foreign exchange holdings at the end of 1978 (at the end of 1977 the U.S. dollar share was at least 85 per cent), it has quickly come to be generally accepted that the foreign exchange substituted would be U.S. dollar balances held in official reserves.

11. Discussion in the Executive Board has focused on Option C, namely, a Substitution Account administered by the Fund which would receive dollar deposits from participants against SDR-denominated claims. It has been suggested in the course of the discussion that sufficiently widespread participation is a basic condition, in addition to that of a large scale of substitution, for the Substitution Account to have the potential for contributing to the objectives on which a considerable convergence of views in the Board is reported. It has also been suggested that since the purpose of the Account is to enhance the position of the SDR as a reserve asset in the system, the characteristics and uses of SDR-denominated assets against which the Account would accept dollar deposits and those of the SDR should be consistent, although not necessarily identical.

12. It is considered that all of the characteristics of the asset, taken together, must be such as to attract the desired broad and substantial participation on a voluntary basis. The yield on the asset, its usability, and its stability are the three chief characteristics examined so far in this context. Special importance has been attributed to the asset's yield. It has been suggested that something very close to the market rate of interest should be paid on the asset if the asset is to be found sufficiently attractive, ^{2/} and that the United States would pay to the Account the going rate for marketable long-term Treasury obligations - which rate could be adjusted at frequent intervals to the current level - to enable the Account itself to pay interest on its liabilities at near "the market" rate.

13. Analysis of the technical aspects of the rate of return relates to two points. First, refinements could be made in the calculation of the rate for the SDR, or the rate for calculating both the actual SDR rate and that on the claims on the Account could be related to quotations for SDR-denominated assets in the market. Secondly, since the actual SDR interest rate is set at 80 per cent of the full combined rate, the payment of a rate on SDR-denominated claims that was much closer to the market rate could inhibit the development of the SDR

itself, and any undue disparity in the interest rate between the two assets might require re-examination of the SDR interest rate.

14. The interest rate provisions would, it is argued, ensure the stability of the asset since an asset expressed in SDRs that was guaranteed to pay an interest rate very close to the equivalent of the market rate on SDR-denominated paper could be expected to sell at a price very close to its face value.

15. Ready availability of the claims on the Account for use by the participants in case of need would be ensured, according to the proposals under consideration, by free transferability among depositors and other holders, with supplementary arrangements that would rely on a moderate use of designation and thereafter on access to the dollars in the Account. The claims should be freely transferable among depositors and other holders on terms and conditions to be agreed between parties to the transfer; and the transfers could cover a wide range of operations, including spot and forward sales, borrowing and lending, use as collateral, etc. Such free transferability would, it is suggested, in itself create an instrument that in principle is marketable, with a minimum price being guaranteed through supplementary arrangements.

16. But a designation mechanism used in the supplementary arrangements will, it is argued, tend to reduce the amount of deposits offered for exchange into SDR-denominated claims, especially if it is based on an acceptance obligation that is a high percentage of the original deposit, while the access to the dollars in the Account to be available beyond the use of designation would undo part of the substitution effect of the Account. In order to reduce recourse to these supplementary mechanisms, it could be made subject to (i) the "requirement of need" which now applies to the use of SDRs under designation, and (ii) an obligation to reacquire claims in the event of the Fund establishing in retrospect that the depositor failed to meet the expectation with respect to the requirement of need, which also is the case in respect of the use of SDRs with designation.

17. A further measure to reduce the need for and recourse to the supplementary mechanisms would be for the Account to levy a charge on any such use. In a broad market, and on the assumption that the interest rate on claims was closely attuned to market rates on comparable paper, a modest charge might, it has been suggested, steer virtually all transactions away from the arrangements provided by the Account itself for the claims to be used by the depositors in case of need.

18. The three elements of designation, encashment, and the charge levied in case of use of designation and encashment would need to be balanced in an optimal way with the requirement of need, taking also into account the fact that the balance may shift over time particularly if over the years a wide market becomes established among holders other

than depositors. A maximum acceptance obligation of 25 per cent in excess of the original deposit is, therefore, suggested as a basis for discussion, with encashment by the Account itself where room for designation was not available, the access to both these supplementary mechanisms being subject to the requirement of need as also to a charge determined from time to time by the Fund. Further, if there were a desire for a provision for the depositors to receive dollars from the Account without having to fulfil the requirement of need, such encashment would have to be at a specified discount on the face value.

19. If the marketability of the SDR-denominated claims is backed by a supplementary mechanism involving designation and acceptance obligations and by that of encashment by the Account itself, the Account would not depend heavily on a secondary market in which non-official holders would have an active role. Nevertheless, the holding of claims beyond official circles is, it is felt, worth considering because the development of a secondary market could be helpful in reducing recourse to designation and encashment. Permitting non-official holdings would also make additional uses of SDR-denominated claims possible - such as for compensating balances in respect of borrowing from banks in terms of SDRs; this would help to enhance the role of the SDR in the system, and would also permit greater reliance to be placed on the market in ensuring liquidity of the SDR-denominated claims.

20. Because an open Account would be subject to short-term speculative influences, and because additional deposits would affect the position of previous depositors, 3/ the substitution of currency balances into SDR-denominated claims should best be attempted on a once-for-all basis. But most Executive Directors see advantage in an Account accepting additional deposits from time to time, as countries become more familiar with the operations of the Account and can take a longer-term view of their portfolios. To minimize the influence of short-term factors, it would be desirable that the opportunity for deposits is not repeated at intervals of more than one year. New deposits during the first years of the Account's operations could be handled by a depositor informing the Fund of the amount it intended to deposit during the next five years, 40 per cent of this amount being deposited initially and no more than 20 per cent in any one year after the initial deposit. Concurrence of the United States would be a precondition of reopening the Account to accept new deposits. 4/ After the initial period, the Fund could take further decisions about reopening the Account.

21. Interest due on the claims on the Account should, in principle, be adequately covered by the long-term U.S. interest rate at which the Account would earn interest on its dollar assets held in long-term U.S. obligations. Although it appears that this would not have been the case either from end-1964 to end-1968 or from mid-1971 to end-1978, it is suggested that this experience is not likely to be repeated. None the less, provisions will be needed to ensure the ability of the Account to pay interest over the long run without drawing on its assets, because the meeting of interest obligations partially from

assets would cause the Account's net worth to deteriorate, which would in turn adversely affect the market value of the claims. Such provisions will need to be other than that of making the interest rate paid by the United States subject to adjustment if the Account's assets were to fall significantly below its liabilities, which was considered in earlier Board discussions, but which was the subject of reservations.

22. It is recognized that the amounts involved are potentially quite large, and payment of interest in SDRs both by the Account (in respect of the claims on it) and by the United States (on its long-term obligations held by the Account) could result in certain complications. At the same time, the making of interest payments in SDRs would not be a major way in which the Substitution Account would enhance the role of the SDR in the system. Consequently, it has been suggested that the payments might be made entirely in U.S. dollars. Alternatively, interest payments on the claims on the Account could be made in additional SDR-denominated claims, while the interest earnings of the Account on the U.S. obligations held by it could add to its dollar holdings.

23. No mandatory amortization by the United States is envisaged, as the SDR-denominated claims on the Account would be part of countries' reserves and a secular decline in the stock of reserves is not to be expected. Further, obligatory amortization by the United States would not serve the purposes of the Account when the United States was in deficit, while any U.S. balance-of-payments surplus would be settled (at least predominantly) in dollars rather than in SDRs or SDR-denominated claims because large dollar balances would remain in official reserves even after the substantial substitution envisaged through the Substitution Account. But the United States could acquire claims on the Account, if it so wished, from their holders on mutually agreed terms, and use the claims so acquired in the same way as claims held by depositors.

Implications of a Substitution Account as Presently Proposed

24. The developing countries have an even greater interest than the developed countries in the improvement of the functioning of the international monetary system, given the present living standards of their peoples and the distance they have to traverse - and the effort involved - to bring these standards up to minimum socially acceptable levels. There are two reasons for their greater concern. First, a better functioning international system may be expected to encourage stable growth in industrial countries, providing expanding and more dependable opportunities for the exports of developing countries, as also for flows of development capital to them. Though trade among developing countries has been rising (and needs to be further developed to the advantage of all concerned), their trade with the developed countries is larger and is of vital significance to the growth of their economies. Higher levels of activity in industrial countries would also provide a more propitious climate for improving the flows of official development assistance to developing countries in terms of

both quality and amount. Secondly, an improved system should reduce erratic fluctuations in exchange rates under a regime of widespread floating. Large variations in the values of major world currencies discourage in particular the growth of newer exports from developing countries, and render more uncertain the cost of their debt servicing. Moreover, as pointed out by Mr. J. de Larosière to UNCTAD V recently, "The development of their terms of trade also becomes hard to predict, and in general the management of their domestic economies becomes much more difficult". Mr. de Larosière rightly added that "This variability in exchange rates may have more far-reaching negative effects - particularly as regards investment...". 5/

25. The Committee of Twenty listed in its introduction to the Reformed System "the main features of the international monetary reform" as it conceived them. In connexion with the proposals for a Substitution Account now under discussion, and particularly since the proposals are stated to be conceived as an exercise in the evolutionary process of reform advocated by the Committee of Twenty, it is appropriate to recall that the following were included by the Committee among "the main features":

- "(a) an effective and symmetrical adjustment process, including better functioning of the exchange rate mechanism...;
- "(c) the introduction of an appropriate form of convertibility for the settlement of imbalances, with symmetrical obligations on all countries;
- "(d) better international management of global liquidity, with the SDR becoming the principal reserve asset and the role ...of reserve currencies being reduced; and
- "(e) consistency between arrangements for adjustment, convertibility and global liquidity...; 6/

The question arises whether current proposals for a Substitution Account are likely to lead towards the above objectives or at least facilitate their attainment. In any event, since the Committee of Twenty regarded it "as of the highest importance that ... action taken in this field (i.e., in the international monetary field) during the interim period (i.e., the "period before a reformed system can be finally agreed and fully implemented") should be consistent with the principles of reform", 7/ the proposals should at a minimum not tend to thwart an evolution in which the international monetary system would acquire the desired features.

26. A substitution account should rightly be expected to contribute directly to the "better functioning of the exchange rate mechanism". By reducing currency holdings, it should dampen fluctuations in exchange rates. The proposals under discussion, however, involve only official currency holdings, out of which substitution into SDR-denominated claims is envisaged on a large scale over time. Apart from the instability involved in carrying out substitution on a number

of occasions instead of once for all, there is a question whether the contemplated substitution - even on the large scale that is desired - could have a discernible impact on exchange rate fluctuations. Official claims on the United States and identified official Eurodollar holdings are placed at SDR 167.5 billion at the end of 1978. Even after the substantial substitution envisaged in the present proposals, it is clear that large holdings of liquid dollars would remain in depositors' reserves; it is not contemplated that non-official holdings, which are much larger, would be touched. According to the Bank for International Settlements, Eurodollar deposits of banks amounted to some \$500 billion, excluding inter-bank deposits, at the end of September 1978; after adjustment for identified Eurodollars officially held the figure could be placed at some \$450 billion. Not only are the non-official holdings of a much larger magnitude than the official holdings, but it is they rather than the official holdings that have been volatile. As regards the exchange-rate instability of the past few years, it is the movements in non-official holdings that have made the greatest impact, because most central banks do not engage in speculative switching of currency holdings. Even apart from the instability arising directly from the fact that the contemplated substitution is not a once-for-all affair, since a reopening of the Account from time to time is envisaged, the Substitution Account under discussion in the Executive Board is not likely to make a material impact on exchange-rate instability. The reasons for this are that (i) the envisaged substitution relates to official balances which are known not to be volatile for the most part, while (ii) the much larger Eurodollar balances which are non-officially held and which are volatile are not involved in the substitution.

27. Further, even the relatively modest currency holdings that are to be substituted are not necessarily expected to result in an equivalent net absorption of reserve currency balances. Since the United States is interested in reducing the role of the dollar as a reserve currency, a decline in dollar balances through substitution would presumably not be counteracted by continuing deficits in the United States. On the other hand, current proposals do not involve any amortization obligations for the United States. There also appears to be no intention to curtail in any manner the present freedom of the United States in arranging its external payments relations. A successful Substitution Account is predicated upon an improvement in the balance-of-payments adjustment process particularly between the United States and the main surplus countries. In the absence of amortization requirements and of provision for asset settlement, the scheme under discussion does not contain anything that would in itself encourage appropriate adjustment action by the reserve currency countries or by the major surplus countries.

28. Nor does the scheme lead in itself to increasing the role of the SDR in the international monetary system. It is contemplated that the substitution would be into SDR-denominated claims, not into SDR assets. An SDR-denominated claim is a new asset in respect of which depositors into the Substitution Account would receive in the event of the winding up of the Account dollar assets in proportion to their claims. There are no provisions for turning these claims into SDRs

proper. Consequently, the question arises whether the scheme under discussion would make a contribution towards establishing the SDR as the principal reserve asset in the international monetary system.

29. Though consistency is sought between the characteristics and uses of SDR-denominated claims and those of the SDR on the ground that the purpose of the Account is to enhance the position of the SDR as a reserve asset in the system, the SDR and the SDR-denominated claims would remain fundamentally different in that the SDR is an internationally created and managed asset while SDR-denominated claims would be a reflex of the reserve assets created by an individual national authority. This fundamental difference has implications for securing an effective and symmetrical adjustment process through international action, and for promoting symmetrical obligations on all countries in the settlement of imbalances and better international management of global liquidity, as also, as a consequence, for bringing about consistency between arrangements for adjustment, convertibility, and global liquidity.

30. While current proposals are intended to lead, in the long run, to a strengthening of the role of the SDR, the question arises whether they might not have exactly the opposite effect. For example, should the Substitution Account exercise succeed, so that sizeable SDR-denominated claims on the Account came to be held as part of official reserves, the view might gather strength that, in view of their popularity, the SDR-denominated claims rather than the SDR itself should serve as the international reserve asset needed by the system, and that international creation and management of global liquidity through SDR allocations were no longer necessary nor even desirable. On the other hand, should the SDR-denominated claims not gain the requisite strength, the consequences for the SDR could likewise be adverse. It might then be argued that the failure of SDR-denominated claims - endowed as they are with characteristics and uses consistent with those of the SDR - was an indication that the future of the system lay in a direction other than that of giving the SDR a major role in the international monetary system.

31. In addition to an adequate scale of substitution, sufficiently widespread participation is considered a basic condition for the Substitution Account to have the potential for contributing to the objectives underlying the present proposals. The Fund staff has suggested that in order to achieve widespread participation all major official holders of dollar balances needed to be depositors in the Substitution Account, and that half of these holders were developing countries who were members of the G-24. There is a wide disparity in reserve holdings of countries relative to their respective working and other needs, and in relation to their relative economic sizes. Further, the asset composition of official reserves shows wide differences between countries; and to a significant extent the diversity in asset composition does not reflect individual countries' own free choices. A number of developing countries hold large dollar balances in their official reserves because the authorities of other currencies discourage them from holding their currencies beyond levels

much lower than many developing countries would prefer if they had a free choice in the matter. Developing countries that resort to borrowings in the private international capital market - in which the U.S. dollar continues to be a dominant currency - to meet their needs for investment capital as also for balance of payments purposes, are required to hold dollar deposits as compensatory balances for their borrowings from commercial banks. Even on the most liberal assumptions with respect to their usability, SDR-denominated claims would not be exactly as usable as the currency holdings; indeed, it is possible, as will appear later, that the usability of the SDR-denominated claims could be distinctly lower under certain circumstances. Participation on the basis of the present levels of dollar holdings, without taking into account the strength of official reserves relative to the economic sizes of countries, and also disregarding the circumstances under which individual countries have come to hold dollar balances, would therefore not be equitable as between countries - nor as between dollar holding countries.

32. It should also be noted that widespread participation could result in unwinding part of the substitution, particularly during the early periods of the operation of the Substitution Account. Recent developments make it likely that there will be a significant further deterioration in the payments position of non-oil developing countries. The wider the participation in the Account and the larger the size of substitution, the greater would be the possibility of depositors needing to use their SDR-denominated claims to meet balance-of-payments needs. Free transferability of SDR-denominated claims among depositors and other holders on terms and conditions to be agreed between parties to the transfer will create an instrument that is marketable in principle; but it is recognised that thus far the market for SDR-denominated assets is not very well developed. It is therefore proposed that supplementary mechanisms involving the use of designation and resort to encashment by the Account itself should be provided to guarantee a minimum price.

33. At the same time, the fear has been expressed that a designation mechanism, especially if based on an acceptance obligation that is a high percentage of original deposits, will tend to reduce the amounts for which members are prepared to participate. It is therefore suggested that a maximum acceptance obligation be set at 25 per cent in excess of the original deposit. In these circumstances, it may well come about that even with a "requirement of need" provision together with imposition of a charge, encashment at the Account would be resorted to, which would undo the substitution effects of the Account to the extent of encashment. Encashment in the initial stages of the operation of the Account might also have an adverse impact on subsequent operations of the Account.

34. The yield of the asset, its usability and its stability are considered to be the chief characteristics of the asset from the point of view of its acceptability. It has been suggested that from the standpoint of developing country participation in the Substitution Account, there are two desiderata, the yield on the claims and their

liquidity. It has also been indicated that the rate of interest paid by the Account on the SDR-denominated claims could well be set at a level slightly lower than the market rate for SDR-denominated assets, by analogy with the Treasury Bill rate in the United States, which is lower than the rate on certificates of deposit issued by banks for identical maturities. The difficulty with this approach, however, is that payment of a near market rate on SDR-denominated claims could build up pressure for raising the interest on SDRs. There have already been suggestions that any undue disparity in the interest rate between the SDR-denominated claims and the SDR proper might require re-examination of the SDR rate in the light of experience. And along with the SDR interest rate would move up the rate of remuneration and the charges. For the developing countries which are not users of SDRs and which may be expected to increase their resort to Fund assistance, a higher SDR rate and increased charges would be onerous.

35. There is another aspect of the interest rate issue. It is understood that there are at present barely a dozen banks that accept SDR-denominated deposits. Such deposits are virtually insignificant in relation to the total of Eurocurrency deposits. Among the factors responsible for this state of affairs could be the banks' perception of uncertainties affecting the exchange rates of the currencies making up the SDR-basket, as also the diversity of interest rates on bank deposits in those currencies which in varying degrees are determined by domestic considerations peculiar to individual currencies - the disparities in which interest rates are also a factor in exchange rate movements. In any case, the unimportance of bank deposits denominated in SDRs means that there is no rate that can reasonably be considered a market rate on SDR-denominated assets. Thus there is no market rate with reference to which the rate on the claims on the Substitution Account could validly be set at present. Consequently, in connexion with the scheme under discussion, it is difficult to point to a reliable criterion for determining whether any particular interest rate paid on SDR-denominated claims could be considered satisfactory.

36. There is a suggestion in the present proposals that interest on the SDR-denominated claims on the Substitution Account could be paid in additional SDR-denominated claims. As will be seen in later paragraphs, certain provisions in the present proposals impart a degree of sterilization to the reserves held in SDR-denominated claims and a capital loss is possible in respect of them. In addition to the currency balances substituted, the return on them would also be subject to these infirmities, if the interest on the claims is paid in additional claims.

37. The stability of SDR-denominated claims, it has been claimed in the proposals under discussion, would be ensured by the interest provisions. Prices of assets are not always calibrated to the current returns alone. This apart, there is at present no SDR-denominated paper of significance in the market, and consequently no "market" rate on SDR-denominated paper. To ensure maintenance of value of the claims in terms of the SDR very close to their face value, an exchange guarantee of some credibility would be required. In the absence of

such guarantee, the development of a market in the claims and its continuance are not easy to envisage.

38. For the liquidity of SDR-denominated claims, major reliance is placed in the proposals on free transferability on terms and conditions agreed to between parties to the transfer. However, the fact that there are no restrictions on transfers and that the parties are free to agree on the terms of transfers does not in itself ensure the creation of a market. As mentioned in the preceding paragraph, a provision guaranteeing in the last resort reasonable value for the claims would be required, among other things, for the development of a market in them. The proposals postulate use of designation and encashment at the Account to underpin the value of the claims, but both these mechanisms are subject to the "requirement of need" and may also be subject to a charge. However desirable these conditions may seem in order not to impair the financial strength of the Account and its substitution effect, the question arises whether they might have the practical effect of lowering the value of the claims and of impeding the development of a market in the claims. There may, in fact, be a tendency for the proposals in their current form to have the effect of sterilizing the balances substituted rather than supporting the liquidity of the SDR-denominated claims received in exchange. Such de facto sterilization of part of their reserves would be a serious matter for developing countries, particularly since it is intended that substitution should take place in respect of needed reserves, as well as of excess reserves.

39. It is difficult to determine to what extent the establishment of a Substitution Account might lead to stringency in the Eurodollar market, which has been an important source of funds for a number of developing countries. For example, to the extent that balances are, in effect, partially sterilized, as suggested in the preceding paragraph, the demands of non-oil developing countries on the Eurodollar market might increase - and this at a time when private banks are showing some hesitation in adding to their "exposure" in developing countries. Further investigation of this and other aspects of the matter would be advantageous in enabling developing countries to judge how the proposed Substitution Account might affect their interests.

The Need for an SDR-based Mechanism for Substitution

40. It is widely agreed that full advantage should be taken of the present opportunity for making a first step towards reform, if at all possible. Such a first step could, perhaps, be based on the following important points of common agreement:

- (a) the substitution should enhance the position of the SDR in the international monetary system and lead to a reduction in the reserve role of the U.S. dollar;
- (b) the participation in the substitution should be voluntary; and

- (c) the substitution should promote greater symmetry in the position of all countries in the adjustment process.

Equity in the distribution of the burden of adjustment would obviously be a vital element in achieving symmetry in the adjustment process.

41. One way of giving effect to this approach would be to provide for substitution into the SDR proper through voluntary transactions in SDRs between participants in the Special Drawing Rights Department of the Fund. ^{8/} There would be a need for understandings with countries holding strong reserves relative to the size of their economies as to the amounts for which they would individually participate in the substitution exercise so as to reach a reasonable aggregate amount. A special SDR allocation would be required, quite apart from and in addition to the 1979-81 allocation already in force, to all participants in the Special Drawing Rights Department of the Fund in proportion to their quotas in accordance with the provisions of the Articles of Agreement. This special SDR allocation would have to be larger in size than the value of dollar balances being substituted. Provision would be made, along with the special SDR allocation, for the countries with strong reserves to enter into the voluntary acquisition of SDRs from the United States against payment in U.S. dollars. This would imply a willingness on the part of the former countries to exceed, voluntarily, the maximum acceptance obligation of three times the net cumulative allocation, under separate agreements with the Fund.

42. As regards the voluntary transactions in SDRs through which the substitution of the dollar balances would be effected, the United States would be in a position to use the special SDR allocation received by it, as well as its current SDR holdings; it could also make an SDR drawing - or even borrow SDRs from other holders if necessary - for use in the voluntary transactions.

43. An increase in aggregate international liquidity resulting from additional special SDR allocations need not be inflationary. It is, of course, a responsibility of the Fund to regulate the use of SDRs in such a way as to avoid inflationary tendencies. It should be noted that countries that would otherwise borrow from private international capital markets so as to increase their reserves might well forego such borrowing on receiving the special SDR allocation.

44. Substitution through voluntary transactions in SDRs need not involve pressure for any immediate undesirable adjustment action on the part of the United States. Its SDR holdings, depleted by the substitution exercise, could be allowed to be built up over such a period and as gradually as would be in the interests of the world and the U.S. economies.

Conclusion

45. The proposals for a Substitution Account are undergoing continuous

review, and in that process are being, and will continue to be, modified in various ways in response to the views expressed in the Executive Board of the Fund. The discussion in the present paper is necessarily based on a particular spectrum of proposals, but has sought to concentrate on the principal ideas that seemed to be emerging in the course of the debate. A number of questions have been raised that have a profound bearing on the interests of developing countries, and the reaction of these countries to the proposals is likely to depend on the manner in which the issues involved are handled.

46. The following are among the principal questions raised:

- (i) Is it possible to separate the question of establishing a Substitution Account from the wider issues of effective and symmetrical adjustment, an appropriate form of convertibility, and better international management of global liquidity which provided the context in which the Committee of Twenty first considered proposals for such an Account? 9/ Granted that it is important to take the first step towards reform, and that as matters stand at present a "first step" is unlikely to be possible if it is made conditional upon a wide-ranging agreement on reform, is there not still a danger that unless the initial measures introduced are fully consistent with the ultimate goals of reform, the direction of movement may be away from rather than towards reform?
- (ii) In particular, can current proposals be expected to lead to a reduction in the role of reserve currencies in relation to the SDR, or to any improvement in the adjustment process, or to greater symmetry in sharing the burden of adjustment?
- (iii) Is it desirable to create a new asset, an SDR-denominated claim, that differs from the SDR proper, with no provision for the transformation of these claims into SDRs? Is there a possibility that such an asset might actually impede the further development of the SDR? It should be noted that while the SDR is an internationally created and managed asset, SDR-denominated claims are only a reflex of the reserve assets created by an individual national authority.
- (iv) Are the present proposals equitable as among countries, among dollar holders, and as between the substituters and the United States? In particular, are the burdens to be assumed by other countries commensurate with those falling on developing countries through, for example, possible increases in SDR and other Fund charges, possible increases in other debt servicing obligations, the quasi-sterilization of part of foreign exchange

reserves - including "needed" as well as "excess" reserves - and any impact on capital inflows resulting from potentially increased stringency in Eurodollar markets?

- (v) Will reliance on the market solve the problems of the yield, liquidity and stability of SDR-denominated claims as discussed above? 10/ Is there a satisfactory solution to the dilemma posed by the fact that the less advantageous are the SDR-denominated claims in terms of yield, liquidity and stability, the less satisfactory will they be in meeting the objectives of the proposals; while the more attractive the claims are, the more likely are they to be preferred over the SDR?

47. It is to be hoped that in the process of answering these questions ways will be found of establishing a Substitution Account that will take the interests of developing countries as well as of all other Fund members, fully into account.

FOOTNOTES

1. Report of the Executive Board to the Interim Committee on a Substitution Account, Attachment I (ICMS/Doc/79/2 of 2 February 1979), pp. 3-4.
2. Earlier discussions considered payment of interest at the SDR rate and crediting the participants with an extra return which would be at a rate equal to the excess of the full combined rate (i.e. the combined market interest rate on liquid assets in five currencies in terms of which the SDR rate is determined) over the actual SDR rate or some pre-determined fraction of the excess.
3. The impact of additional deposits would depend on the ratio between (i) the SDR value of the U.S. dollar assets of the Account at the prevailing SDR/dollar exchange rate and (ii) the Account's SDR-denominated liabilities.
4. Among the other issues to be sorted out with the United States are: (i) the supply of dollars to the Account as and when needed for its current operations; (ii) determination of the rate of interest on the Account's investments in the long-term obligations of the United States; (iii) medium of interest payments by the United States to the Account; and (iv) issues associated with voluntary amortization and liquidation of the Account.
5. Address by J. de Larosi re, Managing Director of the International Monetary Fund before the Fifth Session of the United Nations Conference on Trade and Development, Manila, 11 May, 1979.
6. Committee of Twenty, International Monetary Reform (Washington, D.C., 1974), p. 8.
7. International Monetary Reform, op. cit., p. 4.
8. This differs from Option B in the Report of the Executive Board to the Interim Committee on a Substitution Account (ICMS/Doc/79/2 of 23 February, 1979) under which the Account would receive dollar deposits from all participants in the SDR Department, in proportion to quotas.
9. See paragraph 25 of the present paper.
10. See paragraphs 34 to 38.

PROPOSAL FOR THE ESTABLISHMENT OF A MEDIUM-TERM
FACILITY WITHIN THE FRAMEWORK OF THE
INTERNATIONAL MONETARY FUND

Sidney Dell*

I. BACKGROUND

Purpose and Rationale of Proposal

1. The basic presumption underlying the proposal is that developing countries may suffer from structural balance-of-payments deficits for which existing institutional arrangements make insufficient provision.

2. The argument, in essence, is as follows. As a result of shifts in the pattern of production, trade or relative prices, which may have thrown up substantial balance-of-payments surpluses in other countries, a developing country may find itself running a current account deficit which is larger than it can finance by capital inflows on acceptable terms, yet which is not the consequence of economic mismanagement or an excessive pressure of domestic demand. For this kind of structural deficit the conventional International Monetary Fund stand-by arrangement, with its short time-horizon and associated conditionality, is not an appropriate remedy. Unless the deficit is the result of a sudden and reversible fall in export prices, the Compensatory Financing Facility will be of no help. Although in some cases the Extended Fund Facility may be of assistance, this Facility is not entirely suited for dealing with situations resulting from factors beyond the control of the country concerned, because it requires the application of standard Fund conditions designed primarily for situations of excess domestic demand. Unless, therefore, such a country can attract an adequate inflow of official or private capital on acceptable terms, it may have to cut back on its imports to an extent dictated either by its own external reserve position, or the terms of a conventional stand-by arrangement concluded with the Fund. Such a cut back in imports is likely to be detrimental to its own development programme, as well as exerting a deflationary effect on the growth of world trade and production. The aim of the proposed Medium-Term Facility (MTF) is to permit such a country to adjust its balance of payments over a longer period of time - usually 5 to 10 years - so that reductions in imports which have adverse effects upon both its own development and the course of world trade can be avoided or minimized.

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The Proposal in Outline

3. The proposal, as set out in paragraph 35 (vii) of the Recommendations of the UNDP/UNCTAD Project's Report, ^{1/} is that:

"a medium-term facility should be established at a substantial level of resources to provide balance-of-payments support over periods of up to 5 to 10 years. The funds for such a facility could be raised in capital markets along the lines employed by the World Bank. The terms and conditions of loans should be adjusted to the circumstances of borrowing countries, and since commercial terms would be inappropriate for the poorest countries, it is a condition for the viability of this proposal that provision should be made for interest subsidies to the countries already eligible for such subsidies under the Fund's oil facility. The facility should be located within the framework of the Fund."

II. THE PROPOSAL IN DETAIL: HOW THE MEDIUM-TERM FACILITY MIGHT WORK

Size of Facility

4. The amount of the financial resources needed to create the MTF would depend upon (i) the number of countries covered by the scheme; (ii) the maximum drawing entitlement of each such country and (iii) the extent to which such countries drew on the new facility at the same time. For example, on the assumption (i) that coverage was in practice confined to non-oil developing countries, (ii) that maximum entitlement was equivalent to 100 per cent of quota (after the Seventh General Review becomes effective) and (iii) that at any given time the maximum drawings outstanding were equivalent to full entitlement by countries whose quotas accounted for half total developing country quotas, or three-quarters of full entitlement by countries whose quotas accounted for two-thirds of total developing country quotas, then the new facility would need resources of a little under SDR 10 billion.

Eligibility

5. The proposed new facility is designed to help countries experiencing payments difficulties arising from forces beyond their control and which are not likely to be self-reversing over the short term. The facility is thus not designed to deal with imbalances resulting from an excessive level of domestic demand or a sudden fall in export prices which is likely to be self-reversing.

^{1/}UNDP/UNCTAD Project INT/75/015, The Balance of Payments Adjustment Process in Developing Countries: Report to the Group of Twenty-Four, 2 January 1979.

6. It is recognized that in most instances there will be difficulty in determining the precise extent to which the payments problems of a particular country derive from domestic or foreign factors, and the extent to which they are reversible in the near term or are more permanent in character. It is also recognized that in many instances a combination of factors will be operating on the external accounts, some of which may indicate eligibility, and some of which may not. In these circumstances, a considerable element of judgment would be involved, and some degree of error in allocating the observed deficit among the various causal factors would be inevitable. Thus, any operational system for determining eligibility would be likely to fall short of the ideal. Even so, it could be expected to represent a marked improvement over present practice.

7. The judgments required in ascertaining eligibility for access to the proposed facility would, however, need to be guided by some objective criteria. These would need to reflect two separate types of external disturbance bearing on the payments situation of developing countries.

8. The first of these is system-wide phenomena unrelated to particular trade flows or identifiable financial transactions. This would arise, for example, from a persistent surplus on the part of a major industrial country resulting from an exchange rate or industrial structure that made it particularly competitive or from the maintenance of an unusually low level of domestic demand. The distribution among other members of the system of the effects of such a surplus would be difficult, or perhaps impossible, to trace, and specific indicators of the magnitude of the impact on other countries are consequently lacking. In this situation, it would appear best to allocate the impact of the surplus among other countries according to quota shares, the rationale being that the size of IMF quotas is the only available comprehensive and internationally agreed measure of the potential vulnerability of national economies to payments disturbances.

9. A second type of situation would arise when external shocks were transmitted to a country through specific trade or financial transactions. This would be the case, for example, when protectionist measures had been taken with respect to current exports, where competition for traditional exports had emerged from new producers or substitute products; where there had been a rapid and sustained increase in the prices of essential imports such as petroleum; or where there had been sustained and secular declines in the prices of major exports. In these cases, access to the proposed new facility would be determined by rough quantification of the disturbances operating on the external accounts.

10. There would, of course, be instances in which both types of phenomena were involved. The recent oil price increase, for example, produced both persistent surpluses and payments pressures through specific trade flows. In such cases a further element of judgment

would be needed in determining which of the above approaches should be followed.

Conditionality

11. Like the Compensatory Financing Facility, introduced in 1963 to assist countries experiencing temporary export shortfalls, and the Oil Facility, introduced in 1974 to assist countries seriously affected by steep oil price increases, the proposed Medium-Term Facility is designed to help countries cope with a problem outside their immediate control: in this case deficits of a structural nature. As with the Oil Facility, therefore, it would be appropriate for access to the new facility to be subject only to first credit tranche conditionality. While it is recognized that the fact that a balance-of-payments deficit is due to factors beyond the control of a country does not necessarily mean that adjustment can or should be avoided, there is a case for saying that the type of upper credit tranche conditionality that is applicable to cases of excess demand would not be appropriate. The Fund's role in such a case is to provide sufficient recycling of resources to permit the requisite adjustment to be programmed over a reasonable period, so as to avoid disruption of the development programme. While the Fund will wish to monitor the progress made in effecting the structural changes required, it will not need to impose a severe regime of fiscal and monetary contraction such as would be required where the disequilibrium originated in domestic economic management.

Terms

12. Purchases under the new facility would normally be made over a period of three or four years, perhaps in 6 or 8 half-yearly instalments. Re-purchases would take place over a period of five to ten years. Precise requirements would need to be varied in order to take account of differing conditions in different countries, and in particular the greater capacity of some countries than of others to increase exports or reduce reliance on imports in the medium-term.

13. Except for low-income countries, interest charges would be equivalent to the interest rate paid by the Fund on its own borrowings (see Financing below), together with a small service charge of the kind levied in connection with purchases under the supplementary financing facility. For low-income countries (defined, for example, as the 60 or so countries entitled to receive loans on concessional terms from the Trust Fund established in 1976 or, alternatively, the rather smaller number of countries entitled to benefit from the Subsidy Account established in 1975 in connection with the Oil Facility) an interest subsidy would be provided. This subsidy could be used to reduce the interest payable by low-income countries to a nominal 1/2 per cent, as in the case of loans from the Trust Fund; or to reduce the non-concessional rate of interest by a certain amount, as in the case

of the 5 per cent interest rate reduction financed by the Subsidy Account.

Financing

14. Although the proposed new facility could in principle be financed by subscriptions of new capital of the kind periodically used to increase quotas, the difficulties experienced in recent years in increasing quotas in line with requirements suggest that a more promising approach may be an issue of bonds by the Fund on the international capital market. Provision for such borrowing is made in the Fund's original Articles of Agreement, and there seem no practical reasons why this should not be done. The Fund should be able to borrow at a 10-year maturity at a highly competitive interest rate. At the same time, the resources that it might need to raise are sufficiently small in relation to the size and elasticity of the international capital market to provide little reason to suppose that borrowing by the Fund would "crowd out" other national or international borrowers.

15. An important advantage of borrowing in the private capital market is that it would give the Fund a considerable power of initiative to mobilize resources without having to go through the difficult and cumbersome procedures involved in securing new resources from governments.

16. To finance the subsidy proposed above to the interest rate paid by low-income countries would be one of the most difficult, but essential, parts of the operation. One possibility would be to invite high income members of the Fund to contribute towards a Subsidy Account of the kind established in connection with the Oil Facility. Alternatively, the profits from further sales of gold by the Fund - beyond those at present envisaged - could be used to finance the subsidy; though this would require the agreement of the U.S. Congress. The sale of an additional 10 million ounces of gold, at the July 1979 price of around \$300 an ounce, would yield a profit of approximately SDR 2 billion - a figure which should permit a substantial subsidy to be provided to low-income countries making use of the MTF during at least the first 10 years of its existence.

A SURVEY OF SOME RECENT PROPOSALS FOR NEW INTERNATIONAL FACILITIES

Michael Stewart*

Introduction

Over the last couple of years, a number of proposals have been put forward for new international facilities which would help to relax the foreign exchange constraints on the progress of developing countries, while at the same time serving to provide some stimulus to output and employment in developed countries.

Four such proposals - those of Venezuela, Mexico, OECD/DAC and UNDP/UNCTAD - are discussed in some detail below. Two other proposals are also discussed, but rather more briefly, since in one case (the Mitsubishi Research Institute proposal) the way in which it would work is unclear, and there seems little immediate chance of its being accepted; and because in the other case (the Swedish proposal) the version of the scheme reviewed - which in any event has much in common with the Venezuelan and Mexican proposals - is in the process of being reformulated.

A concluding section attempts to highlight some of the issues and problems that have emerged from the earlier discussion.

VENEZUELAN PROPOSAL 1/

Basic Rationale

1. It is argued that because of high inflation and high unemployment, low profitability and sluggish productivity, capital investment in OECD countries is stagnating. OPEC surpluses are not being re-cycled on a sufficiently long-term basis. At the same time, non-oil developing countries stay poor and suffer mounting debt servicing problems. In these circumstances the transfer of excess OECD and OPEC savings to developing countries would be mutually beneficial: a sustained increase in demand in the Third World would constitute a new growth frontier for the world economy.

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Objectives

2. The excess savings of OECD and OPEC countries would be pooled and lent to developing countries on a long-term basis. To some extent these funds would be "targeted" towards sectors where world supply bottlenecks threaten to appear in the medium-term. Initially they should also be directed towards projects whose associated imports would tend to match OECD industries with spare capacity, but only for long enough to permit structural adjustments to take place in OECD countries which would encourage a reduction in protective barriers against developing country exports.

Size and Time Horizon

3. Precise figures appear to be lacking, but there are indications that what is envisaged is a flow of \$16-20 billion a year for a period of five to ten years.

Source and Administration of Funds

4. The bulk of the amounts involved - perhaps 75-80 per cent - would be raised by selling Triple-A long-term (12-20 year) "OPEC Development Bonds" in international capital markets, using the technical expertise of private multinational banks to organize and underwrite the issue. OPEC countries would themselves agree to purchase a proportion - 20-25 per cent - of the bond issue, and would act as a "first guarantor" of the bonds taken up by private investors. The World Bank family, to which the funds raised would be transferred, might act as a "second guarantor" to the OPEC countries.

5. The remainder of the money (20-25 per cent of the total) would be subscribed by developed countries, either out of their existing aid budgets, or out of increased aid allocations.

6. The funds would be disbursed through a "Special Window" at the World Bank and the International Finance Corporation, and/or at regional institutions such as the Regional Development Banks.

Use of Funds

7. 20-25 per cent of the total would be channelled to basic needs projects in the least developed countries, presumably mainly on concessional terms. The rest would be lent at commercial rates on a long-term (12-20 year) basis to finance bankable projects in other developing countries.

8. In the short run, loans would be targeted towards projects which might be expected to require imports from industries in OECD countries which were suffering from excess capacity, though this emphasis would only be appropriate for the first few years, until intensified efforts by OECD countries to restructure industry in line with evolving patterns of comparative advantage started to bear fruit. In the medium-term, funds would also be targeted, subject to the agreement of developing countries, toward sectors such as energy and minerals and their related inputs and infrastructure, including indirect basic needs.

Strengths and Weaknesses

9. The Venezuelan proposal, if what is envisaged is indeed a transfer of \$16-20 billion a year for five or ten years, can hardly be criticized for failing to measure up to the magnitude of the problem. But there must be serious doubts about how far such a sum could represent an addition to existing flows. It is true that if OPEC countries subscribed to 20-25 per cent of the issue, some additionality would probably occur, since it could not be assumed that these funds would otherwise have found their way to developing countries; and there would probably also be some lengthening in the maturity of loans. Similarly, OPEC and World Bank guarantees might well result in a considerable increase in the net flow of funds from private institutional investors in OECD countries. But unless the World Bank was able to persuade its members to increase their capital subscriptions, such guarantees might mean some curtailment of World Bank activity in other fields, with a corresponding reduction in the net increase in the flow of financial resources to developing countries as a whole.

10. The same considerations apply, with even more force, to the proposal that 20-25 per cent of the fund should be financed by contributions from OECD governments. It is difficult to believe that more than a fraction of this total of \$4-5 billion a year could represent additional, rather than diverted, aid flows. Thus although in principle one of the attractions of the proposal is that 20-25 per cent of the annual transfer would go to the least developed countries, mainly on concessional terms, in practice these countries might benefit very little: it would tend to be middle-income countries with bankable projects which got the bulk of the additional finance or, at least, finance at longer term.

11. If it were to be concluded, despite these doubts, that there would be a substantial measure of additionality, doubts would still arise over the capacity of developing countries to absorb flows of this magnitude. One view is that the difficulty of finding projects likely to yield a commercial rate of return is already providing a constraint on the flow of resources to developing countries. A more sanguine view is that if more funds were available, and the technical expertise at the disposal of the World Bank and the regional development institutions were expanded, suitable projects could be identified and prepared on a considerably larger scale than at present. Even so, an

increase in project aid of \$16-20 billion a year, or even of half that amount, is unlikely to be achieved except as a result of a build-up over a number of years.

12. Another set of questions is raised by the proposal that funds should be targeted, first towards projects whose import requirements matched the pattern of excess capacity in OECD countries, and later towards projects in such sectors as energy and food. While such targeting could be regarded as maximising the mutual benefits of both developed and developing countries, it could also lead, in both short run and long run, to an emphasis on projects and sectors to some extent at variance with the development objectives of some developing countries.

13. A final question relates to how far - quite apart from the issue of their willingness to provide more aid or guarantees - OECD countries would welcome the stimulus proposed. It has certain strong attractions: it would lead to some increase in exports, output and employment in developed countries and, in the medium term, to some revival of capital investment; and it might ease the problem of adjusting industrial structure in line with the changing pattern of comparative advantage. It might also be argued that the mopping up of excess liquidity in the Eurocurrency markets consequent upon substantial sales of OPEC bonds would help to reduce inflationary strains and exchange rate instability in OECD countries. As against this, there is some skepticism in developed countries about how far increased transfers could be targeted in such a way as to confine increased demand largely to sectors where excess capacity is high and marginal costs low; and, more generally, a widespread conviction that any significant stimulus to demand in these countries at the present time would be likely to intensify inflationary pressures. As long as the control of inflation remains the overriding objective of economic policy in OECD countries, this consideration will continue to loom very large. In the event of a major recession developing, however, attitudes might change significantly.

MEXICAN PROPOSAL 2/

Basic Rationale

1. Although in recent years the international community has managed to recycle funds from surplus to deficit countries on a short and medium-term basis, it has not succeeded - it is argued - in establishing a recycling mechanism to provide long-term finance. The need for such a mechanism is likely to be even greater in the future, as lower long-term growth rates and increased protectionist pressures in the industrial countries constrain the growth of developing country exports, and mounting debt-service problems, particularly in middle-income countries, make it increasingly difficult to finance the growth of imports needed for development.

Objectives

2. In order to marry the existence of spare capacity in the capital goods industries of developed countries with the need - unmet because of foreign exchange constraints - for capital goods in developing countries, long-term loans would be made available to developing countries for the purchase of such capital goods. This process would raise output and employment in the developed countries at the same time as leading to an increase in investment and growth in developing countries.

Size and Time Horizon

3. A fund of \$15 billion is envisaged, which might be disbursed over a period of three to five years. Loans to developing countries would have a maturity of fifteen years or so.

Source and Administration of Funds

4. The proposed new fund would issue bonds with a fifteen year maturity, and denominated in SDRs, on international capital markets. There might be three successive borrowing operations. Potential investors would include the governments and central banks of surplus countries, commercial banks, and institutions such as pension funds and insurance companies. The interest rate offered would be determined in the light of market conditions, and the creditworthiness of the new fund. This creditworthiness would be underpinned by guarantees offered by developed (and perhaps some developing) countries. The general incentive to developed countries to offer such guarantees would lie in the extra output and employment they might obtain as a result of the scheme's operation; more particularly, developed countries which did not themselves subscribe to the new fund's bond issue would only be eligible to supply capital goods financed under the scheme if they acted as guarantors. A secondary market would be established in the new fund's bonds, to enhance their attractiveness by giving them liquidity.

5. The fund would be administered either by an existing institution such as the World Bank or possibly by some new institution.

Use of Funds

6. Long-term loans would be made from the fund to projects, sector programmes and perhaps private firms in developing countries. Such loans would be made only for projects or investment programmes which the World Bank or other managing institution expected to yield an acceptable rate of return. The money would be used to purchase capital goods from other developing countries or from developed countries whose

governments had either purchased or guaranteed some part of the new fund's bond issue.

Strengths and Weaknesses

7. The proposal has some of the advantages and disadvantages of the Venezuelan proposal, though tempered in both directions by the fact that its scale is considerably less ambitious. In principle, it would provide long-term finance to developing countries which had viable investment projects which could not be financed because of a lack of the foreign exchange needed for essential imports; at the same time it would lead to a rise in output and employment in the depressed capital goods industries of developed countries. (The presumption is that OECD countries are suffering from a sustained problem of stagnation rather than a purely cyclical set-back, and therefore that there is little immediate danger of the flow of funds to developing countries needing to be cut back as other sources of demand revive.) Although it cannot be demonstrated that the bonds issued by the new fund would lead to an additional flow of resources, the sums involved are sufficiently small in relation to the size of world capital markets that, provided such bonds were guaranteed by the governments of developed countries, a substantial degree of additionality seems probable. Such additional flows, channelled through an institution such as the World Bank, would probably benefit a wider range of countries than those which have received funds directly from the private international banking system; and might make room for some increase in the proportion of ODA that went to the least developed countries. At the same time, additional resource flows on this scale (perhaps \$3-4 billion a year) would be very small in relation to the size of the total OECD economy, and could hardly be regarded as posing a significant inflationary threat.

8. There are, however, a number of doubts about the scheme. One is that since in principle it contains no concessional element, much of the benefit would be likely to accrue to middle-income developing countries which have already managed to borrow heavily on international capital markets. Although there is no reason in principle why the scheme should not be associated with a subsidy for loans to the least developed countries, there is no provision for such subsidies, nor is it clear how they would be financed.

9. Secondly, although the absorptive capacity of middle-income countries may be relatively high, it is difficult to say how far an increased flow of funds would in practice be absorbed by further viable projects, as opposed to leading mainly to an increase in reserves or an improvement in the debt structure. Although this latter outcome would be useful in relieving balance-of-payments pressures and increasing creditworthiness, it would have no direct effect in increasing the flow of resources or expanding output in developed countries.

10. A related doubt, as in the case of the Venezuelan proposal, concerns the guarantees which it is proposed that developed countries

should offer to ensure the ready marketability of the new fund's bonds. There would be no problem if these countries were willing to provide guarantees that implied a potential net increase in budgetary expenditures, on the grounds that the scheme would raise output and employment, and that in any case the likelihood of the guarantees being called on was relatively small. Similarly, there would be no adverse effect on concessional flows, even if guarantees were regarded as a potential charge on the aid budget, except in the unlikely event of the guarantees being called on. However, the possibility cannot altogether be ruled out that in some countries the act of granting guarantees would be associated with some reduction in the funds allocated to aid. If this were to happen, it would be a factor needing to be set off against any tendency for a larger flow of non-concessional finance to middle-income countries to lead to some diversion of ODA towards low-income countries.

OECD/DAC PROPOSAL 3/

Basic Rationale

1. OECD Ministers noted at the Ministerial Council Meeting in June 1978 that "increased investment in developing countries would contribute to sustained and more balanced world economic growth as well as enhancing development in the countries concerned. Both developed and developing countries, therefore, should have a mutual interest in measures to stimulate investment in developing countries on an economic basis." The proposal is designed to promote such investment.

Objectives

2. In order to help developing countries attract larger and more dependable non-concessional resource flows from OECD and OPEC countries, there should be a major expansion, beyond the levels at present envisaged, in the co-financing operations of the multilateral development lending institutions with private banks. This would stimulate demand and increase production in both developing and developed countries. The thrust of this stepped-up investment should be consistent with the development priorities of developing countries, while focusing on the need to expand output in sectors such as energy, food production, raw materials and processing, and related infrastructure, which are important for sustained economic growth in both developed and developing countries.

Size and Time Horizon

3. No specific figures are mentioned, though at an earlier stage a figure of an extra \$10 billion a year, building up over a few years and then presumably continuing indefinitely, was used for illustrative purposes. It seems possible that something considerably less ambitious is now contemplated.

Source and Administration of Funds

4. The main source of funds would be an increased level of non-concessional lending by the private international banking system, stimulated by an extension of the "umbrella" activities of the World Bank. It is considered that if the World Bank were to announce a clear policy decision to expand co-financing beyond present plans, and take the necessary steps to strengthen its capacity to assist developing countries to prepare an increased number of projects suitable for co-financing, particularly with private bank funds, then considerably larger resources could be borrowed from the international banking system, for example from private banks which have not so far lent to developing countries.

Use of Funds

5. As with present World Bank lending, loans would be made on commercial terms to projects in developing countries which promised an acceptable rate of return. It is envisaged that under the proposed scheme there should be some emphasis on projects in such sectors as energy, raw materials and food production, where supply constraints potentially threaten the growth of both developed and developing countries.

Strengths and Weaknesses

6. One of the strengths of the OECD/DAC proposal lies in its relative modesty: being essentially a scheme to expand the kind of co-financing arrangements which exist on a small scale already, there is little doubt about its technical feasibility. Since it does not call for any increase in concessional aid flows, nor even require budgetary appropriations to provide guarantees for private investors, it enjoys the support of OECD countries - a crucial ingredient in any successful plan to increase resource flows to developing countries. Associating the World Bank to a greater extent with the process of on-lending OECD and OPEC funds to developing countries is likely to increase the stability of these resource flows, while extending the range both of bank funds which are tapped and developing countries which are recipients. Moreover, experience suggests that bank funds which are lent as part of a co-financing arrangement are likely to have a somewhat longer maturity, and carry a slightly lower interest rate, than would otherwise be the case. Finally, the sectoral emphasis of the proposal represents, however tentatively, a rational attempt to secure co-operation between developed and developing countries in tackling problems which, in a medium to long-term perspective, threaten to slow down the economic progress of both groups of nations.

7. However, what may look like the scheme's advantages from one point of view may look like disadvantages from another. For example, the proposal to give some priority to investment in such sectors as energy,

raw materials and food production may appear to some developing countries to reflect the concerns of the North rather than the South. (However, it is not clear that OECD countries would regard this sectoral emphasis as an essential feature of the proposal, and of course the final decision on whether to accept co-financing for a particular project would always rest with the developing country.) Similarly, while the greater sense of security that lenders may enjoy in being protected by the World Bank umbrella might well lead to an increase in the availability of funds, some developing countries may feel that such an association, and particularly the "cross-default" provisions likely to be involved (i.e. the provision that default on any private element in the co-financing package is regarded as constituting default on the World Bank element as well), makes the borrowing of funds in this way a more onerous commitment than if they are borrowed directly from the private banking system.

8. A distinct drawback of the scheme - as of any scheme that relies for an increased transfer of resources entirely on non-concessional lending - is that the main beneficiaries would tend to be middle-income countries with the ability to absorb additional funds in projects likely to yield a commercial rate of return, rather than poorer countries whose main need is for financial and technical assistance on concessional terms. Although in principle a greater flow of non-concessional finance to middle-income countries might displace some ODA, which could then be re-routed to the least developed countries, any displacement effect of this kind would probably be small.

9. The main weakness of the scheme is the obverse of its main strength: the modesty which makes it technically feasible and likely to be acceptable to OECD countries also makes it a somewhat inadequate response to the problem. No estimates are given of the net increase in resource flows that might occur if the proposal were implemented, but it seems likely, at any rate at first, to be relatively small. The lengthening by a year or two of the maturity of bank funds obtained under co-financing arrangements would help a little, but not very much; and countries lacking commercially viable projects of the kind private lenders are likely to take an interest in would not benefit at all.

PROPOSAL FOR A MEDIUM-TERM FACILITY 4/

Basic Rationale

1. The presumption underlying the proposal is that as a result of changes abroad, which may have thrown up substantial balance-of-payments surpluses in other countries, a developing country may find itself running a current account deficit which is larger than it can finance by capital inflows on acceptable terms, yet which is not the consequence of economic mismanagement or an excessive pressure of demand. The existing facilities of the International Monetary Fund do not provide adequate support for cases of this kind, so that the

developing country may have to respond by cutting back its imports in a way that is detrimental to its own development programme, as well as exerting a deflationary effect on the growth of world trade and production.

Objectives

2. The proposed new facility is designed to permit developing countries in this position to adjust their balance of payments gradually, over a period of five to ten years, so that reductions in imports which have adverse effects upon both their own development and the course of world trade can be avoided or minimised. The new medium-term facility would be established within the framework of the International Monetary Fund.

Size and Time Horizon

3. A sum of SDR 10 billion might be of the right order of magnitude. This would permit non-oil developing countries whose IMF quotas accounted for half total developing country quotas to draw their full entitlement simultaneously, on the assumption that full entitlement was equivalent to 100 per cent of quota (after the Seventh General Review of quotas becomes effective), and that developed countries did not make use of the facility.

4. Purchases under the new facility would normally be made over a period of three or four years; re-purchases would take place over a period of five to ten years.

Source and Administration of Funds

5. Funds for the new facility might come from new capital subscriptions by IMF members or, more probably, from bonds issued by the Fund in international capital markets, along the lines of bond issues by the World Bank. The necessary interest rate subsidy for poorer borrowers (see Use of Funds below) could be financed either from contributions to a Subsidy Account made by high-income members of the Fund, or from the profits realized on further gold sales by the Fund.

Use of Funds

6. Developing countries suffering from structural balance-of-payments deficits would be entitled to draw on the new facility. Various guidelines could be employed to help determine whether a country's deficit was structural, rather than the consequence of excessive demand or bad economic management, or the temporary result of a decline in export prices that was likely to reverse itself; but in the last

resort a decision on eligibility would often be a matter of judgment. Since the object of the proposed new facility - as of the Oil Facility introduced in 1974 - would be to help countries to adjust to problems outside their immediate control, it would be appropriate for drawings on the new facility - as in the case of the Oil Facility - to be subject to no more than first credit tranche conditionality. Thus the Fund would need to satisfy itself, during the period that drawings under the new facility were outstanding, that the country was making reasonable efforts to solve its structural balance-of-payments problem in a way that did not disrupt its development programme. Since the distinction between measures to secure a viable balance of payments in the medium term and measures to promote a satisfactory pace of economic development in the longer term is a blurred one, the Fund's periodic monitoring of the country's progress would no doubt need to be conducted in close consultation with the World Bank.

7. Interest charges on drawings under the new facility would normally be equivalent to those paid by the Fund on its own borrowings, plus a small service charge. For poorer countries, however, such terms would not be practicable, and interest charges would need to be subsidized, perhaps in the way they were for poorer countries which drew on the Oil Facility.

Strengths and Weaknesses

8. One factor in favour of the proposal for a medium-term facility is that a strong intellectual case can be made out for it. A number of countries run persistent balance-of-payments surpluses on current account, either because - like OPEC countries - they are critically important suppliers of an essential commodity, or because - like a number of industrial countries - their economies are particularly competitive or export-oriented. But the counterpart of these persistent surpluses must be deficits - many of them also likely to be persistent - elsewhere in the system. Chronic surplus countries such as Germany and Japan sometimes argue that they must be allowed time to re-structure their economies so as to reduce their surpluses; the same latitude should be afforded countries with persistent deficits. If such countries are to be permitted to put their balance of payments on to a viable basis over a reasonable period of time, without having to make violent adjustments of a kind which can disrupt the development process and sometimes cause social and political upheaval, something like the proposed medium-term facility is required.

9. A second advantage of the proposal is that it is technically feasible, and could, in principle, be put into operation relatively speedily. The Fund is entitled under its Articles of Agreement to borrow in the capital markets or currencies of its member countries, provided the member agrees. Similarly, the technical feasibility of establishing an interest rate subsidy in connection with such a facility has been demonstrated in the case of the Oil Facility and loans from the Trust Fund; though of course this is not to say that Fund members collectively necessarily have the political will to agree

that such a subsidy should be provided. Nevertheless, the set of historical circumstances which has left the Fund holding a large quantity of gold whose book value is very much lower than its current market price provides a means whereby such a subsidy might be financed, though further gold sales for this purpose would need the agreement of the U.S. Congress.

10. The main problem about the proposed new facility is that many developed countries, while not necessarily dissenting from some of the underlying analysis, are not persuaded that a new facility is required. They point out that, now that the Supplementary Financing Facility has come into operation, a developing country in balance-of-payments difficulties may draw up to 330 per cent of its quota (or more, if it qualifies for assistance under the compensatory or buffer stock financing facilities). Of this 330 per cent, 140 percent can be drawn on the Extended Facility, under which repurchases do not have to take place until up to eight years after the date of purchase. Thus - it is claimed - both the resources available to support balance-of-payments adjustment programmes by developing countries, and the length of time for which these resources can be borrowed, are quite substantial. In response to the criticism that the conditions on which these resources are made available (beyond the first credit tranche) are much too severe, requiring drastic and frequently inappropriate policy changes by the developing country, it is argued that this is a distorted interpretation of Fund policies, stemming from the fact that in the past developing countries in balance-of-payments difficulties have delayed applying to the Fund until their economic problems are so serious that drastic and unpopular action is essential if the economy is to be restored to health. If countries would approach the Fund at an earlier stage, it is argued, before their economic difficulties became critical, Fund resources could be made available on distinctly easier conditions, even though such conditions would still incorporate the performance clauses associated with drawings in the upper credit tranches.

11. However, such an argument might seem to ignore the fundamental analysis underlying the proposal for a Medium-Term Facility: the fact that developing countries can find themselves with structural deficits which reflect adverse developments in other parts of the world rather than inadequacy in their own economic management. In these circumstances, there is a strong case for developing countries having access to a substantial facility, subject only to their agreement to make reasonable efforts to find a solution to their balance-of-payments problems, rather than one subject to detailed performance clauses, compliance with which would need to be periodically certified by the Fund as a condition of further drawings.

12. If the developed countries could be convinced of the need for a Medium-Term Facility on first credit tranche conditions, technical difficulties might still be encountered in agreeing on the criteria to be used in deciding eligibility to draw on the new facility. Nevertheless, if the new facility had been set up with the good faith of all the parties involved, these difficulties should not prove insurmountable.

MITSUBISHI RESEARCH INSTITUTE PROPOSAL 5/

Basic Rationale

1. It is argued that Keynesian demand management techniques of maintaining full employment inevitably give rise to an inflationary trend, particularly as supply constraints develop. The relatively small scale of government fixed capital formation in developed countries, and the stagnation in technological innovation which is discouraging private investment, mean that if the existing world economic system is to survive, large public investment expenditures need to be conceived and executed on a global scale.

Objectives

2. A "Global New Deal" would be initiated, in accordance with which a number of "super projects" involving several nations would be prepared and implemented. Many of these projects would develop new sources of energy and increase food production. Developed countries would benefit from increased demand and a stimulus to technological innovation, and developing countries from the multiplier effects on income and employment of the projects of which they were the recipients.

Size and Time Horizon

3. \$13 billion a year would be spent directly, with multiplier effects, annual expenditure would be about \$25 billion a year. This would go on until the end of the century, so that by that time over \$500 billion would have been spent.

Source and Administration of Funds

4. The \$13 billion a year would be contributed, as official development assistance, by the industrial and OPEC countries: \$5 billion collectively by the U.S., Germany and Japan, \$5 billion by OPEC and \$3 billion by other industrial countries. A new organisation would need to be set up to administer these funds.

Use of Funds

5. Among the "super projects" mentioned for illustrative purposes are the greening of the Sahara, Sinai and Arabian deserts, constructing a canal across the Kra Isthmus and a second Panama Canal (in Nicaragua), creating a vast lake in the Congo and Chad regions of central Africa by damming the Congo river, and constructing a dam across the Bering Straits.

Strengths and Weaknesses

6. Although the scale on which the proposal is conceived may well be commensurate with the size of the problems the world is facing, it seems unlikely to find ready acceptance among either developing or developed countries. Although it is not clear how the proposal would be administered in practice, developing countries might wonder how the huge extra disbursements of ODA envisaged were going to benefit them, and particularly their poorer members. Similarly, there are no indications that either OECD or OPEC countries are at present prepared to contemplate increased official development assistance on anything like the scale which is proposed.

SWEDISH PROPOSAL 6/

Basic Rationale

1. It is pointed out that one of the greatest paradoxes of our time is the co-existence of unemployment and unused capacity in industrial countries with deep and increasing poverty in many developing countries, particularly the poorest. However both the stagnation and unemployment in developed countries, and the poverty in developing countries, would have been even worse if developing countries had not borrowed heavily in order to keep up their imports. In this situation massive resource transfers can benefit both groups of countries.

Objectives

2. There should be a massive transfer of resources which would support the industrialization process in developing countries while at the same time, through its stimulative effect on output and employment, increase growth in developed countries. This would facilitate a long-term structural transformation in developed countries, shifting resources from contracting to expanding sectors, and thus in turn reducing protectionist pressures and providing growing export markets for developing countries.

Size and Time Horizon

3. No quantification of what "massive" resource transfers might mean is provided. Nor is any particular time period specified, though there is some discussion of both a relatively short-term, counter-cyclical resource flow, and a more permanent one.

Source and Administration of Funds

4. Funds would come from the excess savings of OECD, and possibly

OPEC countries. The presumption is that these funds would be borrowed on market terms, though the faster rate of growth in developed countries that would be stimulated by the scheme would in due course permit some increase in ODA as well. No particular mechanism for organizing the transfer of these funds is proposed, though there is some discussion of the need for greater involvement of governments and international organizations in the re-cycling process.

Use of Funds

5. Funds would be lent at commercial rates. To maximize their utilization, they might to some extent be steered towards particular countries or sectors where absorptive capacity was high, though in the longer run it would be important to use concessional aid flows to increase the absorptive capacity of poorer countries and regions. There might also be some scope for steering these non-concessional flows towards particular sectors, such as energy and raw materials.

6. To minimise the inflationary effects on developed countries, funds might also be steered, in so far as it was practicable, towards projects whose need for imports could mainly be satisfied by industries in developed countries where capacity was particularly under-utilised. It might also be possible to take account of the effect of developing countries' increases in demand for capital goods on the balance-of-payments imbalances among the developed countries themselves.

Strengths and Weaknesses

7. The Swedish proposal has much in common with some of the other proposals that have been put forward, particularly those of Venezuela and Mexico. One of its strengths is that it stresses the mutual benefit which could accrue to both groups as a result of a massive transfer of resources from developed to developing countries: a higher level of investment and output in developing countries would stimulate output and investment in developed countries, which would in turn lead in these countries to faster growth, lessened protectionism, and the provision of more resources - including those on concessional terms - to developing countries.

8. As against this, there appears to be a widespread view in industrial countries that the effects of the kind of massive transfer of resources contemplated in the Swedish proposal, even though it might be felt initially by the relatively under-utilized and high productivity export industries, would be highly inflationary; and there is at present little disposition to take additional inflationary risks. Another weakness of the proposal is that it is not clear what mechanism would be used to promote a massive increase in the transfer of resources; there is no discussion, for example, of the possible role of the kind of government guarantees of long-term private lending that are suggested in the Venezuelan and Mexican proposals.

CONCLUDING OBSERVATIONS

1. All the six proposals discussed earlier are concerned in one way or another with the transfer of real resources from developed to developing countries, either as medium to long-term loans at market rates of interest or - occasionally - as concessional aid. Beyond this, several of the schemes - notably the Venezuelan, Mexican and OECD/DAC proposals - have a good deal in common, while the proposed Medium-Term Facility and the Mitsubishi proposal are, in their separate ways, distinctly different from the others. Thus while it would be possible to conceive of a single scheme which was some kind of amalgamation of the Venezuelan, Mexican, OECD/DAC and Swedish proposals, the MTF and Mitsubishi schemes could not be incorporated in such an amalgamation. The MTF, Mitsubishi, and one of the other schemes (or some amalgamation of them) could each be operated on its own, or in combination with one or both of the others.

2. No conclusive evaluation of the pros and cons of these different schemes can be provided, since different countries and groups within countries have different interests and objectives: and what looks like an advantage to one observer may look like a disadvantage to another. Nevertheless, the mutual interest of both sets of countries in promoting a bigger and more stable flow of resources from developed to developing countries is an element which, rightly, runs through all these proposals, and which should not be lost sight of in the course of any disagreements that arise about the merits and demerits of particular schemes.

3. The Mitsubishi proposal, though novel and challenging, is unlikely to be widely regarded as providing a solution to the problems with which developing countries are at present most concerned. It is not clear how the scheme would work, or which countries or groups would benefit; and the probability that industrial and OPEC countries are going to increase their ODA by \$13 billion a year in the foreseeable future would appear to be low.

4. The proposed Medium-Term Facility is a response to developing countries' long-standing criticism of IMF conditionality. It would provide balance-of-payments assistance on a five to ten year basis, and on first credit tranche conditions, to developing countries with balance-of-payments difficulties that were structural (rather than the result of excess demand or export fluctuations) and which therefore needed to be dealt with in a medium-term perspective, and in a way which did not disrupt the development process.

5. Although a strong case can be made out for the MTF, this case is not necessarily accepted by developed countries or the IMF itself. They are inclined to argue that existing facilities, including the Extended Fund Facility and the Supplementary Financing Facility, are sufficient to cope with the problem, and that the conditions attached to these facilities are only strict when a country's economic situation

has been allowed to deteriorate badly, and drastic action is needed to restore the balance.

6. If these objections to the MTF could be overcome, no insuperable technical problems should arise in setting it up. The main difficulty would lie in financing the interest rate subsidy that poorer countries would need if they were to make use of the new facility. Contributions by richer countries or further gold sales by the Fund might be the answer.

7. The other four proposals are all concerned with ways of increasing the flow of long-term lending from developed to developing countries, mainly on non-concessional terms. It may be useful, in order to summarize some of the characteristics of these proposals, and highlight some similarities and differences between them, to set out brief answers to a few simple questions which might reasonably be asked about them.

How much money is involved?

8. The Venezuelan proposal appears to envisage \$16-20 billion a year for five to ten years - though such a figure is extremely ambitious. The Mexican proposal implies perhaps \$3-4 billion a year for three to five years - \$15 billion in all. The OECD/DAC proposal mentions no figures, but something of the same order as, or smaller than, the Mexican proposal seems likely.

Where would this money come from?

9. In the case of the three main proposals at least, from surplus funds in OECD and OPEC countries - for example funds now invested in the Eurocurrency markets. In the Venezuelan case there would also be some ODA.

What reason is there to suppose that these flows would be additional to existing flows?

10. There are plenty of funds - the result of OPEC surpluses and the sluggish rate of investment in OECD countries - seeking profitable but safe investment outlets. To encourage private institutions such as the international banks to increase their lending to developing countries, the OECD/DAC scheme would bring them - as already happens to some extent - under the "umbrella" protection of the World Bank, by expanding co-financing arrangements. In the case of the Venezuelan and Mexican proposals, the price of increased loans from private institutions would probably be a guarantee of these loans provided by the governments of developed countries. Whether such governments would be willing to provide such guarantees is a crucially important

question. A point in favour is that all the proposals under consideration would lead to some increase in output and employment in developed countries, where unemployment is high and short-term prospects for growth are gloomy. A point sometimes raised against, at a time when public expenditure is everywhere under hostile scrutiny, is that such guarantees might in some countries be associated with some reduction in the funds allocated to aid.

11. It should be noted, however, that even if the additional resources forthcoming as a result of these proposals were relatively modest, there would still be some lengthening of the maturity of loans - particularly under the Venezuelan and Mexican proposals - which would considerably ease the debt burden on a number of countries.

On what terms would these loans be made available to developing countries?

12. In most cases, at commercial rates; though the Venezuelan proposal envisages - probably rather unrealistically - that considerably increased sums might become available for lending on concessional terms. Maturities range from ten to twelve years under the OECD/DAC co-financing proposal (i.e. a year or two longer than existing private bank maturities) to fifteen years under the Mexican scheme. The Venezuelan proposal seems to imply maturities ranging from twelve to twenty years.

Who would administer these funds?

13. In all cases, the World Bank family and/or the regional development banks (though the possibility of a new institution is mentioned in the Mexican proposal).

Where would the new funds go?

14. To projects which were commercially viable (except for such concessional funds as might be raised under the Venezuelan proposal). However the pooling and underwriting of risks inherent in the three main proposals would mean that a number of countries which had not been able to attract funds directly from individual private banks should now be able to do so.

Would some countries benefit more than others?

15. Because of the commercial criteria governing the lending of these funds, it is quite possible that middle-income countries with bankable projects and relatively high absorptive capacity would benefit more than poorer countries; but a number of factors might work to offset

this. For example, the Swedish proposal envisages more concessional assistance in order to help poorer countries prepare suitable projects; and as flows of non-concessional funds to middle-income countries increased, it should be possible to divert a greater proportion of ODA to poorer countries.

Is there a sector bias in these proposals?

16. All four proposals emphasize the advantages of some proportion of increased non-concessional lending being directed towards sectors, such as energy and food, where supply difficulties in the future threaten to damage the growth prospects of both developed and developing countries. However, this sector bias is not necessarily an essential element in any of the proposals, and would in any case require the agreement of developing countries to be effective.

17. A different kind of sector bias might arise under the Mexican proposal, since funds would only be made available for the purchase of imported capital goods. This could lead to an undue emphasis on capital-intensive projects.

What is the attitude of developed countries to these proposals likely to be?

18. All these proposals stress the mutual advantages to developed and developing countries which would result from their implementation, and up to a point developed countries would agree with this: this would be in favour of higher exports and lower unemployment. Nevertheless, they are also very concerned at the possibility that any significant increase in the pressure of demand might intensify already powerful inflationary tendencies. This may be why the OECD/DAC proposal contains no quantification; and it is certainly why the other three proposals are contemplated without enthusiasm in a number of quarters. In the event of the onset of a new world recession, however, the possible inflationary disadvantages of these proposals might come to seem less important than their advantages for output and employment.

FOOTNOTES

1. The Venezuelan proposal was worked out in the course of 1977, and outlined by President Perez at a press conference after the December 1977 meeting of OPEC Ministers at Caracas.
2. Proposal for a long-term facility for financing purchases of capital goods by developing countries, put forward by the Mexican Government at the meeting of the Development Committee which took place in Mexico City in April 1978. A more detailed account of how the proposal might work is provided in a companion paper to the present one.
3. A Proposal for Stepped-Up Co-Financing for Investment in Developing Countries, OECD, Paris, May 1979.
4. Proposal put forward in UNDP/UNCTAD Project INT/75/015, The Balance of Payments Adjustment Process in Developing Countries: Report to the Group of Twenty-four, 2 January 1979, para. 35(vii). A more detailed account of how the proposal might work is provided in a companion paper to the present one.
5. A Proposition for the "Global Infrastructure Fund", presented by Masaki Nakajima, President, Mitsubishi Research Institute, Tokyo, August 1978.
6. Massive Transfer of Resources: Background and Problems for Further Analytical Work (Informal Working Document circulated by Permanent Mission of Sweden to the United Nations, 3 May 1978).

AN ELABORATION OF A PROPOSAL FOR A LONG-TERM FACILITY
FOR FINANCING PURCHASES OF CAPITAL GOODS BY
DEVELOPING COUNTRIES (MEXICAN PROPOSAL)

Michael Stewart*

I. BACKGROUND

Purpose and Rationale of Proposal

1. The main purpose of the Mexican proposal is to marry the need for capital goods in the developing countries with the present underutilization of the capital goods industries in the developed countries, by promoting long-term loans to developing countries for the purchase of capital goods. Such a process would be mutually beneficial, raising the level of investment in the developing countries while at the same time increasing the level of output and employment in developed countries.

2. Underlying the proposal is the assumption that it would generate an additional flow of funds from developed to developing countries. While there is no way in which the correctness of this assumption can be demonstrated, in relation to the size of the proposed new fund the world capital market is so large and the process of credit-creation so elastic that it seems implausible to argue that the bulk of the financial resources flowing into the new fund would necessarily be diverted from elsewhere. In so far as there was any corresponding fall in the flow of shorter-term funds to developing countries from the world's private banking system, these countries would still benefit from the consequent lengthening of the maturity structure of their debt. There is in principle no concessional element in the present proposal, and thus no particular reason to expect it to affect the existing level of concessional aid. If, as seems possible, middle-income countries proved to be the main recipients of loans from the new fund, there might be room for some diversion of concessional aid towards the poorer countries which benefited from it less. Alternatively, if it proved possible to establish a subsidy account for poorer countries, along the lines of the subsidy account established in 1975 for drawings on the oil facility by the most seriously affected nations, poorer countries might be able to benefit significantly under the present proposal.

3. The proposal also assumes that the present high level of unemployment and spare capacity in developed countries is not a short-term cyclical phenomenon, which would imply that any increased

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transfer of resources resulting from the scheme should be cut back when the upswing develops, but a prolonged period of stagnation which calls for a substantial stimulus.

Key Elements of Proposal

4. Key elements of the proposal, as set out in the paper submitted by the Mexican Government to the Development Committee in April 1978, are as follows:

- (i) A long-term fund of \$15 billion would be created by borrowing on world markets. The borrowing operation might be in three successive tranches of \$5 billion each.
- (ii) The fund would be managed by an international financial institution such as the World Bank.
- (iii) Bonds would be denominated in SDRs, with a 15-year maturity and yielding a market rate of interest. Thus there would be no concessional element involved. A secondary market would be established in these bonds.
- (iv) Loans would be made from the fund to projects, sector programmes and perhaps private firms in developing countries. Such loans would be made only for projects or investment programmes which the World Bank or other managing institutions expected to yield an acceptable rate of return. These loans could be guaranteed by the governments of the borrowing countries, or by the governments of certain developed countries.
- (v) Capital goods would be purchased out of these loans both from developed countries whose governments (or other institutions) had made, or guaranteed, loans to the fund; and from developing countries.

II. THE PROPOSAL IN DETAIL: A SUGGESTED APPROACH

Nature of Fund

5. The aim is to inject an increase in purchasing power into the world economy over a relatively short period of time. Thus the objective would be to disburse the \$15 billion (approximately SDR 12 billion) over a period of perhaps three to five years. This would be consistent with three SDR 4 billion bond issues at approximately yearly or two-yearly intervals. (There is, of course, no reason why a second SDR 12 billion programme should not be organized at the end of the initial three to five year period, should it seem appropriate at the time.)

Administration of Fund

6. The fund could be administered either by a new international financial institution, or by an existing one. In the latter event, the World Bank would probably be the most appropriate location of the new fund: some of the Bank's expertise both in raising money on world capital markets and in assessing the viability of projects and sector programmes in developing countries could be put at the new fund's disposal. Administrative costs could be covered by a small initial or recurrent service charge on the loan extended.

Borrowing by the New Fund.

7. The new fund would offer bonds with a 15-year maturity, and denominated in SDRs, to governments or central banks, commercial banks and long-term investors such as pension funds and insurance companies. The interest rate offered, which could vary for each of the three SDR 4 billion bond issues envisaged, would be determined in the light of the prevailing level of interest rates, and the perceived creditworthiness of the new fund. The creditworthiness of the new fund, in turn, would depend upon:

- (i) The nature of its lending policies.
- (ii) The extent to which its loans were underwritten or guaranteed by the governments of developing and developed countries. These two questions are discussed in turn below.

8. The presumption is that all developing countries would be eligible for loans from the new fund. Loans would be for 15 years, denominated in SDRs, and subject to the rate of interest paid by the new fund on its own 15-year bonds, together with a small service charge. Loans would only be made on the understanding that the money lent would be used to purchase capital goods from one or more of a list of countries comprising (i) all developing countries; (ii) developed countries of which the governments or certain other institutions had purchased some minimum amount of the bonds issued by the new fund; (iii) developed countries whose governments had guaranteed some minimum amount of the new fund's bond issue.

9. A number of specific issues would need to be settled in establishing the terms of reference of the new fund's lending policies.

10. A first question relates to the desirability of maximum or minimum limits on the size of loan to be made under the scheme. If the rate of disbursement is to be, as was implied earlier, of the order of SDR 2 1/2-4 billion per year, some very large projects will probably need to be financed, and to impose a limit on the size of loan that may be made for any particular project might in itself be undesirable. On the

other hand, if no upper limit is imposed on the loans that may be received by any particular country, a disproportionate share of the total could go to a relatively small number of countries. A different kind of problem is that if no lower limit is placed on the size of applications for loans, the need to process a large number of small applications might overwhelm the technical resources at the disposal of the new fund. The argument is probably stronger for a minimum than a maximum limit; but in either case any initial determination might need to be provisional, and subject to amendment as the new fund accumulated experience.

11. A second issue is the kind of project which should be eligible for loans from the new fund. Projects which conventional investment appraisal techniques suggested were likely to yield an acceptable rate of return would clearly be eligible and it is to these that the proposal is mainly addressed. More of a problem would be projects which were likely to yield an acceptable rate of return on the basis of an appropriate set of shadow prices, but unlikely to do so on the basis of actual market prices. Such projects, where the social rate of return was higher than the market rate of return, would include those where the social cost of an input, such as labour, was lower than the actual cost; and those where output was deliberately underpriced for income distribution or other reasons. The difficulty about including such projects in the scheme is that (depending on the proportion of project expenditure accounted for by imported capital goods) the money rate of return might be insufficient to service or amortize the loan from the new fund, so that it would need to be underwritten by the government. Where governments were willing to do this, however, there would be a strong case for regarding such projects as eligible for loans under the new scheme.

12. A third issue, partly related to the previous one, is whether private firms, as well as public sector projects or programmes, should be eligible for loans from the new fund. In favour of eligibility is the argument that in many countries considerable unsatisfied demand for imported capital goods may exist in the private sector, particularly in the manufacturing industry; and that to exclude private firms from eligibility would undesirably restrict the benefits of the scheme, and curtail especially the flow of funds to projects whose profitability can be assessed on normal market criteria. As against this, bondholders and guarantors might be reluctant to see loans made to private sector projects without some form of guarantee from the developing country's government; and many governments might be unwilling to provide this. However, such guarantees might not be needed: the IFC makes loans to private firms without requiring or accepting government guarantees.

Guarantees

13. It is essential that the bonds issued by the new fund should prove attractive to the governments of developed countries and of other countries - such as OPEC members - with balance-of-payments surpluses,

and to private institutional investors. The denomination of the bonds in SDRs would in itself be a helpful feature; but the corollary of this is that developing countries whose currencies depreciated significantly over time in relation to the SDR would need a correspondingly high cash flow to be generated by their projects if interest and redemption payments were to be met. If the new fund is to borrow in world capital markets on terms which permit loans to be made to developing countries at acceptable rates of interest, some kind of guarantee of the value of its bonds is likely to be needed.

14. Guarantees taking the form of a lien on the capital goods purchased under the scheme are unlikely to prove widely acceptable; and in some cases the same might be true of guarantees offered by the governments of developing countries which received loans. Thus the bulk of any guarantees that were forthcoming would need to be provided by the governments of developed countries. Since such guarantees would constitute a potential charge on the budgets of developed countries, the question arises to what extent this might lead to a reduction of aid flows through other channels. There would, however, be no adverse effect on concessional flows, except in the unlikely event of the guarantees being called on. However, the possibility cannot altogether be ruled out that in some countries the act of granting guarantees would be associated with some reduction in the funds allocated to aid. If this were to happen, it would be a factor needing to be set off against any tendency for a larger flow of non-concessional finance to middle-income countries to lead to some diversion of ODA towards low-income countries.

15. There are a number of specific forms which a system of guarantees might take. One (ex-ante) approach would be for developed countries which wanted to qualify as suppliers under the scheme to agree in advance to provide guarantees of the interest payments and redemption of the bonds issued by the new fund in proportion to some objective criterion, such as their voting power in the World Bank, or share of its total subscriptions and supplementary resources. Countries whose governments subscribed to the new fund's bonds would be permitted a reduced guarantee liability, the extent of the reduction varying, up to a cut-off point, in line with the proportion of the successive SDR 4 billion tranches subscribed to.

16. An alternative (ex-post) approach would be to relate the proportion of guarantees provided by particular countries to the proportion of the total orders for capital goods financed by the new fund which are placed in that country. An advantage of this approach would be that individual countries might feel that the costs they could incur as a result of any possible default would be more closely related to the benefits they actually received than under the first approach. As against this, the possibility of "switching" means that no country could be sure that the increase in the output of its capital goods industries resulting from orders financed by loans from the new fund really represented an equivalent net addition to output.

IMPLICATIONS OF A SUBSTITUTION ACCOUNT FOR THE EUROCURRENCY MARKETS

Fred H. Klopstock*

I. Introduction

1. Now that it is becoming quite likely that a substitution account will be established at the IMF in the not-too-distant future, several third world governments are becoming increasingly concerned over the possibility that shifts of monetary reserves to such an account would give rise to stringencies in the Eurocurrency markets - the major source of balance-of-payments support and project financing for developing countries. This paper addresses this concern. It evaluates in some detail the prospects for central banks shifting holdings in the Euromarket to claims on the proposed account and appraises the effects of such shifts on the market's lending potential. For purposes of exposition, the analysis distinguishes between likely shifts out of existing central bank holdings in the market and out of prospective reserve accruals in the immediate years ahead.

2. At the time of writing, the scope, characteristics and endowments of the account are an unknown quantity. The observations put forth in this paper are based on the assumption that the account will offer relatively attractive, and at the same time fairly stable, interest rates, a high degree of transferability of claims (though not automatic marketability) and considerably greater exchange rate stability than dollar assets. These assumptions may well be too optimistic. If so, the substitution account's potential to attract Euromarket deposits will be diminished and possibly substantially less than projected in this study.

II. Role of Central Monetary Institutions as Suppliers in the Euromarkets

3. In the light of current planning, it appears reasonable to assume that, at least in the early years of the proposed account's existence, it will be accessible solely to monetary authorities. Thus, shifts of deposits from the Euromarket to the account will be confined in the years ahead to those of official holders. Such deposits have grown by leaps and bounds during the last five years and have been one of the major growth factors in the market. Their large increase constitutes a major change in the reserve portfolio behaviour of central banks. As emerges from the table below, central monetary institutions now account

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for \$130 billion of total Euromarket deposits, or about 25 per cent of the market's net size.

Eurocurrency Market Size (end-year)
(in billions of dollars)

1970 1971 1972 1973 1974 1975 1976 1977 1978 1979
(June)

Gross Size

Liabilities to

Monetary Authorities	15	15	25	40	60	70	85	110	120	130
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Commerical banks	65	100	140	210	240	310	380	460	605	640
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Non-banks	30	30	35	55	75	80	100	125	165	190
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Total	110	145	200	305	375	460	565	695	890	960
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Net Size ^{a/}	65	85	110	160	215	250	310	380	475	510
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Source: Morgan Guaranty Trust Company estimates, except for June 1979, which represent the author's estimates.

a/ i.e., after allowance for double counting.

4. Euromarket liabilities to monetary authorities have increased more than eightfold in the decade beginning in 1970, a rise far exceeding that of non-banks and close to that of the rise in the market's net size. But the reader should keep in mind, that, as the table shows, both non-banks (such as corporations and non-bank financial institutions), as well as commercial banks, are substantially more important suppliers to the market than central monetary authorities. Thus, the impact of any diversion of central bank deposits from the Euromarket must be appraised against the background of total supplies to the market, including the likely responses of these other supplier groups to the interest effect of such a diversion. This subject is discussed in section VI below.

5. Another relevant fact, though not revealed by the table, is that of late the rise of monetary authorities' placements has taken increasingly the form of Eurodeposits other than dollars, i.e. deposits in the Euro-DM, Euro-Yen, Euro-Sterling and Euro-Swiss Franc markets. It is well to keep this in mind since the desire of official depositors to switch their Euromarket holdings to the substitution account may well be confined to their dollar holdings, as they may regard their other Eurocurrency placements as meeting their monetary reserve diversification objectives. Unfortunately, there are no comprehensive statistics on the currency denomination of official deposits in the Euromarket available to the public - only those on aggregate placements

in the European countries reporting to the BIS. As of end-June 1979, two-thirds of total such deposits were denominated in dollars, 20 per cent in Euro-DMs and 6 per cent in Swiss francs. However, we do know that official Euro-DM deposits at the end of 1978 amounted to DM 30 billion, or approximately \$17-20 billion, which would account for about 15 per cent of all official deposits. Add to this amount a rough estimate of \$15 billion of official deposits in other non-dollar sectors of the market, and the Eurodollar component of central bank deposits would add up to approximately \$95 billion, about 80 per cent of total official deposits.

6. Thus, if the assumption that central monetary authorities will wish to hold on to their non-dollar assets in the Euromarket is correct, then the maximum potential for diversion from the Euromarket to the substitution account is much lower than conveyed by the official deposits shown in the table. One might add that this assumption may well be reinforced if it turns out to be true that the account will invest its balances solely in long-term US Treasury securities. Unless the value of claims on the account is guaranteed in SDR terms - and it remains to be seen whether such a guarantee can be negotiated - claims on the account would then be regarded in all likelihood merely as another instrument for central bank investments in US dollar assets.

7. Still, the assumption of central monetary authorities confining any shifts from the Euromarket to the substitution account to some part of their Eurodollar assets needs to be qualified. The growing preference of central banks for non-dollar Eurodeposits may change over time. Any worsening of the long-run exchange rate outlook for what are now considered strong currencies may well induce monetary authorities to shift some of their existing non-dollar assets in the market to the substitution account.

8. Furthermore, in any appraisal of the diversion potential of existing Eurobalances held for official account, one should make allowances for the use by central banks of their non-Euromarket assets for acquiring claims on the substitution account. After all, many central banks hold all or the bulk of their foreign exchange reserves in national money markets, notably the US money market. Making use again of Morgan Guaranty estimates, the official balances in the Euromarket account for about 42 per cent of total foreign exchange reserves. If we were to use IMF statistics, which cover only identified official holdings of Eurocurrencies, the latter add up to no more than 28 per cent of official foreign exchange holdings. Official Eurodollar holdings identified by the IMF are 31.8 per cent of total dollar-denominated foreign exchange reserves.

9. Delving further into these statistics, we find, however, that in the asset portfolio of most major official Eurocurrency depositors, assets held in the US money market play a relatively small role. With few exceptions, these depositors hold the major part of their reserves in the Euromarket and the remainder for the most part in the domestic money markets of the Federal Republic of Germany, Japan and, to a

lesser extent, Switzerland. The available statistics appear to indicate that among major central bank Eurodollar depositors only those of Saudi Arabia, Iran, Norway, Austria, Colombia, Venezuela and Nigeria hold some portion of their reserves in the US money market. Conversely, the bulk of the official holdings in the United States market, now amounting to approximately \$140 billion, including both marketable and non-marketable Treasury notes and bonds, are held by a few central banks in industrial countries such as the Federal Republic of Germany, Japan, Switzerland, Italy and France - all countries that are not depositors to any important extent in the Eurocurrency markets. Central banks also hold fairly substantial funds in the Federal Republic of Germany (approximately \$7.5 billion equivalent) and in Japan (perhaps \$4 billion equivalent). Most of these balances appear to be held by the monetary authorities of developing countries that are also large holders of Euromarket deposits, but again what has been said above about their presumed reluctance to shift balances in the non-dollar sector of the Euromarket into SDR-denominated claims also applies to central bank reserves in domestic money markets other than those in the US. We thus arrive at the important conclusion that, with the exception of the few countries mentioned above, major official holders of Eurodeposits, once they decide to shift all or part of their monetary reserves to the substitution account, will not be able or willing to make use, to any important extent, of their relatively small holdings in the US and other domestic markets. Again with the exception of a few countries, notably Saudi Arabia, the shift would almost entirely involve only Eurodollar deposits.

10. In order to obtain a better insight into likely shifts of assets from the Euromarket to SDR-denominated claims, it would be useful to know something about the regional and individual country distribution of official Euromarket assets. Statistics on the regional distribution are few and far between, but a rough estimate, based partly on IMF sources, would place Eurocurrency assets of the oil-exporting countries at \$75 billion. Official reserve placements in the Eurocurrency market by the monetary authorities of the industrial countries may add up to \$20 billion, by the authorities of the non-oil primary producing countries to \$30 billion, and by monetary authorities in socialist countries of Eastern Europe to \$5 billion.

11. Among individual central banks with official Eurodeposits in excess of \$5 billion are first of all those of Saudi Arabia (with likely holdings adding to several tens of billions of dollars), of Spain, Brazil and possibly of India and Kuwait. These are very rough estimates, based on known or estimated foreign exchange holdings of these countries, estimates of their official holdings in the United States money market, and with even lesser accuracy of their holdings in the markets of the Federal Republic of Germany, Japan, Switzerland and the United Kingdom, including balances held at the respective central banks.

12. On the same basis, it may be estimated that central banks with more than \$2 billion in the Euromarkets include those of Austria, Indonesia, Israel, Libyan Arab Jamahiriya, Iraq, Malaysia, Norway,

Nigeria and Venezuela. Those with more than \$1 billion include the central banks of Chile, Colombia, Republic of Korea, Mexico, the Philippines and Thailand.

13. Among developed countries, only Austria, Norway and Spain are major Euromarket depositors. None of the G-10 countries (and Switzerland) hold more than a few hundred million dollars in the market, as they agreed in June 1971 not only not to increase their deposits, but also to run off existing deposits as they mature. At that time, their deposits amounted to \$3 billion, including deposits at the Bank for International Settlements. This agreement has recently been renewed.

14. The interesting conclusion, emerging from these very rough estimates, is that any diversion of official Eurodeposits to the substitution account and any consequent impairment of the developing countries' ability to borrow in the Euromarket can occur only if the monetary authorities of developing countries themselves should decide to shift sizable funds - either voluntarily or as a result of some pressure - into SDR claims. With few exceptions, they are the only important official depositors. Moreover, a sizable number of the developing countries mentioned above are large-scale borrowers in the Euromarket, notably Spain, Brazil, Iran, Indonesia, Nigeria, Venezuela, Chile, Republic of Korea, Mexico and the Philippines. If they wish to support the lending potential of the Euromarket, they would presumably maintain, if not increase, their holdings in the market.

15. Another interesting fact emerging from the listing of Euromarket placements by individual central banks is that only a handful among them are in a position to shift sizable amounts out of the market. Still another important fact is that any decision of the principal holders of monetary reserves in industrial countries to place them in the substitution account will have no noticeable effect on the Euromarket.

16. In view of the pivotal role of the Saudi Arabian Monetary Authority (SAMA) as an official supplier to the Euromarket, a few words need to be said about that country's monetary reserves. SAMA's monetary assets stood at \$57 billion at the end of October 1979, according to an interview of the New York Times with its Governor, Sheik Abdulaziz al-Quraishi. However, only \$16.6 billion of this amount is designated by SAMA as liquid foreign exchange reserves, most of which, he said, are held in dollar assets. According to the Governor, an additional \$7.7 billion, presumably invested in fairly liquid assets, represent the backing for the Saudi currency, the remainder, \$34 billion, being composed of gold, long-term investments and other assets that cannot be disposed of quickly. Among such assets are probably sizable long-term Eurodollar Certificates of Deposit which SAMA is known to have purchased in volume.

17. It cannot be determined on the basis of official statistics how

much of SAMA's holdings, which by now probably exceed \$60 billion, are invested in the Euromarket. Total Middle East oil-producing countries' holdings in the London Euromarket add up to \$28 billion, sizable amounts of which are held by the Bank Markazi Iran, various Kuwaiti official agencies, the Iraq central bank, as well as some non-official holders. Still, it is a reasonable assumption that a major part of the \$28 billion belong to SAMA. Add to SAMA's holdings in London those held in several other Eurocurrency centres, and there is then no doubt that they add up to very impressive amounts. However, the average maturity of Saudi Eurocurrency holdings may be assumed to be far longer than that of other holders. Thus, a large part of SAMA's Eurocurrency deposits are not available for immediate transfer to a substitution account. Nevertheless, in view of the strong backing by the Saudi Arabian authorities of the establishment of a substitution account, SAMA's ability to shift within a relatively short time span many billions of Eurodollars into SDR-denominated claims must be a major element in any appraisal of the effect on the Euromarket of the account's operation. But such an appraisal should also take into account that, in view of the traditionally prudent and conservative management of SAMA's assets, any shift of Eurodollars into SDR claims is likely to take into consideration both the impact on the market as a whole and, in particular, the basic interests of developing countries dependent for balance-of-payments support and project financing on a well-functioning Euromarket. SAMA, moreover, as has been mentioned before, holds very sizable assets, both short-term and long-term, in the US money and capital markets, including Federal agency securities, some of which are presumably approaching maturity. There is thus a good possibility that SAMA, if it decides to acquire large amounts of SDR-denominated claims, will fall back at least in part on its dollar assets in the US.

III. Motivations of Central Banks for Euro-Market Placements

18. Though we have established the overall parameters of potential shifts from the Euromarket to the substitution account - and gained some insight into the diversion potential of individual central banks - we still know very little about the likely response of official holders to the lure of the proposed substitution account. For this, we must ask ourselves first of all what is it that has made central banks of the developing countries show such a decided preference for the Euromarket over other investment options and whether this preference will fade once a substitution account has become operative.

19. The motivations have been of a varied type. For the monetary authorities of the Middle East oil-producing countries the anonymity of Eurocurrency deposits has been a major consideration. The monetary authorities of some of these countries have sought assurances from their depositories in the Euromarket, including the branches of US banks, that the amounts that they have deposited with them will not be revealed, and these assurances have generally been honoured, though on occasion deposits in some individual official account in some US branches have been leaked. On the whole, however, these monetary authorities have been pleased with the fact that what they consider the

confidential status of their holdings in the Euromarket has been protected.

20. Central banks in both oil and non-oil-producing developing countries have found Eurodollar deposits attractive because their yield is substantially higher than that for US money market assets of comparable maturity. This consideration has been of major significance for those central banks that depend on the income earned on their monetary reserves for covering their cost of operation. Often, US banks are able to persuade potential depositors to place their balances with their overseas branches rather than with the head office, so as to avoid the need for the banks to hold required reserves. Moreover, central banks often have been inclined to place balances in the Euromarket, rather than with US banks, because the latter are not able to pay interest on deposits with a maturity of less than 30 days. Thus, central banks, by placing funds with Eurobanks, are able to earn interest on what are quasi-operating balances.

21. Another major factor making for increased use of the Eurocurrency market has been the desire for reserve diversification away from dollar assets. Central banks are clearly concerned about the declining value of the dollar. A number of central bank governors have expressed this concern vociferously. Many central banks have become multi-currency basket peggers, having abandoned their exclusive link with the dollar. As the performance of the dollar in exchange markets deteriorated, an increasing part of the reserve gains of developing countries has been reported to have been placed in non-dollar currencies. The potential new reserve currency countries, the Federal Republic of Germany, Switzerland and, to a lesser extent, Japan, have made sometimes strenuous, though generally only half-hearted, efforts through reserve requirements and quasi-exchange controls (e.g. Switzerland) to discourage both official and unofficial capital inflows. This in turn has caused central banks interested in diversification of their reserves to make use of the Euromarket sector for their respective currencies. Also, interest rates for these Eurocurrencies, precisely because of various controls, have at times been substantially higher than for similar instruments in the respective domestic markets for these currencies.

22. For the central banks of major borrowers from the Euromarket among developing countries, notably Brazil, Mexico, Republic of Korea, the Philippines, Iran and a few others, still another motivation has been the decisive consideration. This has been the desire, and in some cases the compelling need, to provide compensatory balances to banks in London and elsewhere which have been major lenders to official and semi-official borrowers in the respective developing countries, including in some cases the central banks themselves. Often, though not always, such balances have been provided in response to formal or informal requests. Even if compensating balances were not an immediate consideration for Eurodeposits, some of these central banks welcomed the fact that additional Eurodeposits expanded the lending potential of a market from which they might have to borrow some time in the future. Having close banking ties to major lenders, quite irrespective of the

immediate need for funds, has been important to several central banks in developing countries.

23. Altogether, the observations in this section point to powerful forces that make Euromarket investments a preferred outlet for central bank reserves of developing countries. There is little doubt that it will be very difficult for the proposed substitution account to match the attractions of the Euromarket to central monetary institutions. This remains true even if we make allowance for the possibility that SDR-denominated claims may be superior to Euromarket deposits in one important respect, i.e. relative yield stability. Central banks primarily interested in yield stability may find SDR claims superior to short-term Eurodeposits as well as short-term assets in other international money markets, even if the claims' yield is considerably less than obtainable elsewhere. If the account would be able to provide in addition exchange rate protection, some central banks may be tempted to disregard the Euromarket's outstanding attractions. However, if the account would not be endowed with both these elements, few central banks should be expected to agree to large shifts from the Euromarket to SDR-denominated claims, and no more than a minor part of existing Eurobalances will be transferred to the substitution account. Since at this point of time it is by no means certain that the United States government or any other official entity will be willing to provide an exchange rate guarantee of the SDR value of claims on the account, considerable scepticism is in order with respect to the attractiveness of claims on the substitution account relative to Euromarket deposits.

IV. The Liquidity Aspect

24. Central banks, in placing their monetary reserves in the Eurocurrency market, have not been primarily motivated by liquidity considerations. From the viewpoint of liquidity, investments in US Treasury securities, because they are traded in deep, broad and efficient secondary markets, are far superior to time deposits and even marketable CDs whether issued by US or Eurobanks. Liquidity of aggregate holdings in the Euromarkets can be achieved, however, quite easily, though at the price of yield sacrifices, by holding a sizable portion of deposits in the overnight sector of the Euromarket, by rolling over continuously other very short-dated placements and by proper spacing of deposits with extended original maturities.

25. Liquidity of monetary reserve holdings is of particular significance for primary producing countries because of the price volatility of their major exports and the consequent wide swings in their reserve positions over relatively short-time periods. Thus, they have been typically interested in holding an appropriate amount of their reserves in highly liquid form, either in the Euromarkets or in other international markets. Liquidity is a highly valued investment consideration for central banks in developing countries also because their day-to-day cash needs have come to run into large amounts. In order to determine their needs, they typically appraise the likely

course of their countries' receipts and expenditures on trade accounts over relatively short-time horizons and also give consideration to prospective debt service payments, as well as other receipts and expenditures affecting cash flow patterns. In this manner, they obtain an idea of amounts required for relatively near-by periods for the settlement of their foreign exchange transactions with their commercial banks, and the foreign exchange required by their governments and public, semi-public and private corporations. At times cash flows will leave central banks in a comfortable working balance position, while at other times they face sizable shortfalls. In the aggregate, the operational exchange requirements of central banks for daily transactions undoubtedly run into many billions of dollars. The question arises whether a substitution account will be as suitable for covering immediate or fairly immediate cash requirements of central banks as marketable securities and short-dated deposits in international money markets.

26. It remains to be seen whether a substitution account can be designed that would match the liquidity of short-dated assets in international money markets. It has been suggested that SDR claims should be freely transferable among depositors, subject to terms and conditions agreed to between parties to the transfer. However, as has been pointed out elsewhere, 1/ such provisions do not in themselves guarantee the emergence of an effective market. It has been suggested that for the development of a market, a guarantee of reasonable value for the claims would be required. 2/ Such guarantees would have to be buttressed, in the view of the authors of the proposal, by transfers organized by the IMF to designated depositors in a sufficiently strong balance-of-payments and gross reserve position to buy additional claims. It has been further proposed that in order to reduce recourse to such supplementary mechanisms, central banks that would use them would have to prove a "requirement of need" similar to the one that now applies to the use of SDRs under designation. A further measure to reduce recourse to the supplementary mechanism would be for the account to levy a charge on any such use.

27. These proposals cast doubt on the usefulness of SDR-denominated claims for meeting immediate transaction balance requirements. Transfers that are associated with elements of compulsion and the possibility of lengthy negotiation will have little appeal to central banks that in the light of their prospective cash flows must place a very high value on the ability to encash their claims at very short notice. They surely will look entirely useless to those central bank depositors in the Euromarket whose monetary reserves have shrunk close to operational requirements. Moreover, designation would diminish the voluntary nature of deposits in the account on which developing countries insist.

28. In the light of the distinct possibility that the liquidity of substitution claims may not fully meet the requirements of central bank portfolio managers, one may question whether they would even be willing to commit large parts of their prudential reserves to the account. Typically, these managers allocate a certain proportion of their

foreign exchange holdings to a secondary reserve. Its function is to provide a buffer for replenishing liquidity balances if they should become unexpectedly depleted. Portfolio managers usually allocate to such secondary reserves, government securities with maturities of up to one year and deposits in Euro- and other banks of up to six months to maturity. If these managers are confronted with having to prove need for encashment of SDR claims under circumstances when such a need may not be immediately apparent, they will prefer to continue holding such a buffer in money markets rather than in SDR-denominated claims. Altogether, it would appear that for these reasons many billions of dollars or dollar equivalents now held in either the Euromarket or national money markets would not become candidates for conversion into SDR-denominated claims, if contribution to the account would remain voluntary.

29. The conclusion emerges that unless other provisions can be negotiated that would assure liquidity at the nominal value of the claims, central banks would be inclined to allocate to SDR-denominated claims only foreign exchange holdings in excess of those required for transactions or secondary reserve purposes. Of course, one cannot exclude the possibility that they may be asked by the IMF to "stand up and be counted" by making some contribution to the substitution account. But contributions made under some sort of "moral pressure" may be assumed not to add up to very large amounts. Token contributions by developing countries of, say, \$5 billion, or even \$10 billion, in the aggregate would not affect to any extent a market with a net size of more than \$500 billion.

30. There are, indeed, several major central bank depositors in the Euromarket that now dispose of aggregate reserves substantially in excess of immediate and more distant liquidity needs. Several of them can thus allocate to SDR claims very substantial amounts if they wish, or can afford, to disregard the considerations that have caused them to give preference to the Euromarket in their reserve investments. Among them are again primarily the OPEC countries, such as Saudi Arabia, Kuwait and perhaps Iran and Indonesia. On the other hand, central banks of non-oil-producing countries, such as Brazil and the Republic of Korea, which are among the larger Euromarket depositors, in view of their rising trade deficits and rapidly increasing interest and amortization payments on their external debts, are in no position to tie up appreciable portions of their nominally large reserves in an account on which they may have to fall back in the not-too-distant future. Thus it appears that liquidity considerations reinforce earlier contentions in this paper that among major official depositors in the Euromarket only a handful will be able and willing to shift sizable portions of their existing Eurodollar deposits into SDR-denominated claims.

V. Disposition of Future Reserve Accruals

31. Altogether, the foregoing observations appear to indicate that no more than a few tens of billions of dollars are presently available for

diversion from the Euromarket to SDR-denominated claims, i.e., amounts possibly far in excess of the programmed magnitude of the account in its early years. However, there is every reason to anticipate that availabilities will rapidly escalate in the next two years. In 1980 and 1981 - unless, unexpectedly, crude oil prices decline substantially - large transfers of monetary reserves to the OPEC countries are a virtual certainty, as are burgeoning balance-of-payments deficits of oil-importing countries. The expected surpluses will accrue for the most part to those few OPEC countries that already hold reserves in the Euromarket far in excess of their immediate and secondary reserve needs. At the same time, the monetary reserves of some of the developing countries that are likely to suffer from rapidly rising current-account deficits will decline substantially as their borrowings, unlike in years past, will probably fall short of their deficits. Some of them may actually prefer drawing down their ample reserves so as to reduce their additional borrowings in international financial markets at prevailing interest rates.

32. This scenario raises the spectre that at the time a substitution account will become operative, say in 1982, the portion of official monetary reserves that may then be available for investment in SDR claims will have risen substantially. Thus, in the light of the prospective concentration of reserve accruals in countries that already have sizable excess reserves invested in the Euromarket, a well-functioning and effective substitution account in a few years can count on attracting a rapidly rising portion of aggregate official deposits in the Euromarket and in fact of aggregate foreign exchange reserves. As of today, the amount of Euromarket balances likely to be converted is far too low a proportion of the net size of the market, and also too low relative to its annual growth rate, to produce market stringencies. However, it is entirely conceivable (though one cannot make firm predictions) that in a few years' time, as a result of large accruals to the reserves of several central monetary institutions with large excess reserves, primarily in the Middle East, these institutions will have the ability to pull out of the market such large amounts that its ability to recycle balance-of-payments surpluses would be seriously impaired. And this threat may well gain greater immediacy as the market will no longer be fed, as it was in recent years, by additional balances from the central banks of non-oil-producing developing countries. In fact, their likely withdrawals of funds may well add to emerging shortfalls.

33. While the threat to the Euromarket emerging from the prospective shift of monetary reserves to a few OPEC countries with large surplus holdings should not be underrated, the grave developments outlined above may not come to pass. In the first place, the magnitude of the substitution account remains uncertain. If it is to be limited in size, the problem under review automatically becomes much less threatening. In any case, the central monetary institutions of the oil-producing countries may well be in agreement with the governments of other developing countries that the Euromarket's recycling capacity should not be endangered by wholesale withdrawals of funds. On the basis of their past performance, the major surplus holders among OPEC countries may be expected to act in a responsible way in their reserve

portfolio policies. They may well be persuaded to hold on to their reserve portfolio policies. They may also wish to enter into new institutional arrangements through which to make a respectable part of their reserve gains available for direct financing of developing country deficits. This would still reduce potential supplies to the market, but may at the same time reduce demand pressures. And as a precaution against market disturbances, members of the Group of Twenty-Four could conceivably take the initiative in proposing limitations on annual transfers to the substitution account with a view to safeguarding the interests of developing countries that wish to borrow from the Euromarket.

VI. The Response of Other Supplier Groups to Emerging Pressures in the Market

34. An appraisal of official shifts from the Euromarket to SDR-denominated claims must take cognizance of the fact that the market's outstanding characteristic is its great breadth and variety of supplies. The actual and potential sources of Eurodeposits are very diverse and widely dispersed geographically. Apart from central monetary institutions, they include countless banks, non-bank financial institutions, and transnational and other corporations in virtually all parts of the world. As shown in the table on page 2 of this study, placements by commercial banks and non-banks are far in excess of those by central monetary institutions. In the immediate years ahead, pending the establishment of a substitution account, additional placements by monetary authorities may well outpace those of other depositor groups, but in the aggregate suppliers other than central banks are likely to remain more important than official depositors.

35. The lessons of experience demonstrate not only that aggregate supplies continuously increase, but that there is also a high degree of supply flexibility and elasticity in the market. As to the market's growth pattern, a glance at the table on page 2 shows that never a year has passed during the 1970s when any of the three supplier groups have not added substantially to their aggregate takings. The causes of this phenomenon are varied and apply in varying degrees to the major supplier groups. Perhaps the principal factor for the rapid growth of commercial bank supplies to the market is the continuous increase in the world's money supplies, not in the least as the result of the desire of central banks to use money injections into their financial systems to sustain the growth of economic activity. Recurrently such injections have failed to be translated into domestic credit expansion because of tendencies to stagnation in their respective economies. The resulting excess liquidity in domestic money markets then leaked into the Euromarkets. The rapid growth of central bank supplies, on the other hand, can be traced primarily to the balance-of-payments deficits of the United States. The resulting flood of dollars descending upon the world came to rest in part in the reserves of developing countries, including those in overall deficit on their balance-of-payments accounts, and were then invested in the Euromarket. The liquidity-creating effects of US balance-of-payments deficits have also contributed to increases in commercial bank supplies to the market.

Dollar inflows into financial systems augment the reserve positions of banks and thus induce them to acquire dollars or third currencies for placement in the market. Moreover, quite often central banks, in order to absorb excess balances in their money markets, have deliberately through favourable swap arrangements, induced commercial banks to re-export dollar inflows into the central banks' coffers.

36. The continuous rise of bank placements in Euromarkets also owes much to the fact that banks in countries with domestic money markets that are narrow or non-existent tend to use the Euromarket as a profitable outlet for their growing cash reserves. And banks in the United States, since the lifting of the Voluntary Credit Restraint Program, have for a variety of reasons at times added huge amounts to their aggregate holdings in the Euromarket.

37. Non-banks have placed their expanding liquid resources in the Euromarket in ever-growing amounts. This group includes transnational corporations both in the United States and elsewhere whose treasurers take advantage of the fact that rates in the Euromarket typically exceed - sometimes by substantial margins - rates paid by banks in domestic money markets, primarily, though not solely, because Eurobanks do not incur costs for maintaining reserves in central banks. Wealthy individuals in many parts of the world are also using the Euromarket on a large scale. So do non-bank financial institutions, such as investment and money market mutual funds. It is interesting to note in this context that in the first eight months of 1979, non-banks in the United States added no less than \$12.6 billion to their deposits in the overseas branches of US banks. Add this many billions of dollars deposited in non-US banks in Europe, Canada and elsewhere. Quite obviously, there is a learning process going on here as an increasing number of corporations and individuals in the United States, as well as throughout the rest of the world, discover the attractions of the Euromarkets.

38. There is no reason why the secular growth of banks and non-bank deposits in the Euromarket should not continue in the years to come. In the five years 1974-1978 the annual growth of the market's net size (excluding the increase in official deposits) averaged almost \$50 billion. Even if the market's growth rate should decline, future deposit increases from non-official sources should go a long way to offsetting likely shifts of official deposits to SDR-denominated claims.

39. As to supply elasticity, experience teaches us that many Euromarket suppliers respond with alacrity to any widening of the differentials between Euromarket deposit rates and rates for comparable money market instruments in their domestic markets or in third markets. This is not surprising, since many depositors are free up to a point to choose the market in which they will place their investible balances. There are, of course, considerations that put constraints on such switches, such as exposure limits for commitments in specific currencies and for specific sovereign risks. But these limits apply only to a rather limited extent to commitments in the Eurodollar market

relative to the US money market, or the Euro-DM market relative to the domestic money market of the Federal Republic of Germany. Thus, whenever differentials between rates in the Eurodollar market relative to those in the US money market widen, very substantial funds of both United States and foreign origin will move out of the United States market into the Eurodollar market, often via the branches of US banks, though usually not in sufficient amounts to obliterate entirely the differentials.

40. In the context of this paper, this means that any widening of rate differentials between the Euromarket and the US money market owing to shifts of official funds into SDR-denominated claims is likely to set in motion offsetting movements into the Euromarket of funds held in the US money market by United States and foreign commercial banks and non-banks. As rates in the Euromarket escalate relative to comparable rates in other markets, moreover, substantial balances placed in a variety of domestic money markets, by residents of the countries concerned, will tend to flow into the Euromarket. Still, the magnitude of the resulting capital movements may conceivably fall short of official transfers out of the Euromarket. Regardless of rate levels, the amounts available for such shifts, though sizable, are not infinite. In the unlikely case that central monetary institutions would shift within a short time span many tens of billions of dollars into SDR-denominated claims, it is difficult to conceive a corresponding flow into the Eurocurrency market out of other money markets. In any case, one must take into account likely reactions of monetary authorities if such movements should assume large magnitudes. Some of them would surely impose selective exchange controls as such movements begin to imperil their monetary reserves or undermine stability in their money and credit markets. Thus, supply elasticities are likely to diminish rather rapidly after major investor groups have taken advantage of rising rates and rising rate differentials among money markets in favour of Euromarkets. Therefore, massive and sudden transfers by central monetary institutions in amounts exceeding, say, \$40 billion would indeed cause stringencies in the market. However, more modest and gradual transfers, say in annual amounts of \$20 to 30 billion, would probably be readily digested by the market, as they will be quickly offset by accelerated shifts of private funds into the market. This is not to say, however, that such capital movements would not leave a mark both in domestic financial markets and in the monetary reserve positions of central banks. Altogether, it is not unlikely that, as pressures in the Euromarket are cushioned or offset by new inflows into the market, stringencies will develop in some domestic financial markets, including those of some developing countries if they permit their residents to export unlimited amounts of short-term capital into the Euromarket. Moreover, the capital account of their balance of payments would deteriorate. These considerations reinforce earlier arguments in favour of some form of restraint on any transfers of Eurodeposits to SDR-denominated claims.

VII. Conclusion

41. As this study has shown, a very large part of official deposits in

the Euromarket is held by a few monetary authorities in the Middle East. In theory, it is conceivable that shifts of funds out of the Euromarket into SDR-denominated claims for the account of these authorities might be on a scale sufficient to cause stringencies in the Euromarket. In practice, such shifts are highly improbable because of the prudent and responsible investment behaviour of the Middle Eastern monetary institutions. Moreover, the rules under which transfers to the substitution account take place will need the prior approval of Fund members, who are therefore in a position to require the Fund to take steps to avoid sudden or disruptive movements of funds.

42. The study points to the possibility that by the time a substitution account becomes operative, holdings of several OPEC central monetary institutions in the Euromarket may well have risen by rather large amounts from current levels, as will have risen their aggregate reserve holdings in excess of immediate and prudential needs. In all likelihood, their interest in diversifying the currency composition of their sharply expanded holdings will by then have increased further. Yet, a meaningful diversification into non-dollar assets, even if confined to reserve accruals, will then be even more hopeless than at present, as it would probably lead to a sharp decline in the value of their dollar assets. Thus, their desire for finding a haven for their dollar assets such as a substitution account, even if the exchange value of SDR-denominated claims is not fully guaranteed, may become ever stronger. Any consequential danger of disruptive movements would be mitigated if the IMF were to put a ceiling on the growth of the account. In the absence of such a ceiling, the emerging trends in the geographical distribution of monetary reserves suggest some action by members of the Group of Twenty-Four that are major borrowers in the market. They could seek assurances from other members of the Group, and perhaps from a few other governments, to abstain from disruptive shifts from the Euromarket into SDR-denominated claims.

43. The study has brought out the often neglected fact that many central banks whose governments and public agencies are major borrowers from the Euromarket also happen to be major suppliers to the market. This would support the view that rather large amounts of official Eurocurrency deposits will not be available for conversion into SDR-denominated claims. It is inconceivable that the central banks in countries borrowing large amounts in the Euromarket would undermine the market's strength or antagonize individual lenders, quite apart from the fact that they must deposit sizable funds with the lenders as a precondition of loans to public entities in their countries. Moreover, in the light of emerging shifts in the distribution of monetary reserves, non-OPEC central banks in developing countries will consider an ever-growing proportion of their reserves as serving prudential purposes and hence wish to safeguard their liquidity. Others will find their reserve balances approaching, if not falling below, transaction needs. Neither group will be inclined to shift their Euromarket balances into an asset whose liquidity at face value bears question marks.

44. Another conclusion emerging from the study is that the governments

of developing countries that are large borrowers in the Euromarket need not harbour any fears of large-scale monetary reserve shifts by OECD countries into SDR claims causing Euromarket stringencies. Even though these countries own approximately one half of world foreign exchange reserves, their Euromarket deposits are far too small for their withdrawal to cause disturbances in the market.

45. Finally, the study suggests that the market's growth has been, and will be, sustained by fundamental forces that tend to shift large parts of the continuous increases in liquidity reserves of major banks and corporations to the Euromarket. Such shifts, moreover, tend to accelerate whenever widening rate differentials favour placements in the market. The paper has also demonstrated that the aggregate non-central bank supplies are, and will remain, a multiple of official placements. Thus, the conclusion emerges that, so long as arrangements are made to hold official shifts from the Euromarket to SDR-denominated claims within some reasonable range, further accretions to the market by supplier groups other than central banks will tend to offset official withdrawals.

IMPACT OF A SUBSTITUTION ACCOUNT ON EURO-CURRENCY
AND RELATED LENDING TO DEVELOPING COUNTRIES

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Introduction and Summary

1. This paper examines the implications for balance-of-payments finance available to less developed countries (LDCs) of the operation of an IMF substitution account. The initial focus is on the supply of funds to LDCs from the Eurocurrency market. But, as the paper argues, it makes little sense to consider the Euromarkets in isolation from other channels of international lending which are close substitutes for Eurocurrency loans. Furthermore, it is important to consider not only the direct effects of a substitution account on financial markets, but also whether there may be indirect effects resulting from changes in national monetary policies associated with the substitution account.

2. The main conclusions are, first, that a substitution account will in itself make little difference to financial market conditions. And secondly, that its indirect repercussions could go either way, but are perhaps more likely to make financial conditions easier than they would otherwise have been. There is thus no presumption that LDCs will be penalized by the creation of a substitution account.

3. These conclusions are qualitative, i.e. independent of the size of the substitution facility. On the other hand, the provision requiring the counterpart of deposits in the substitution account to be invested with the US Treasury might one day be modified, particularly if the deposits became very large. In that case the substitution account might be a vehicle for enlarging the IMF's role in balance-of-payments financing. There are difficulties, however, in adapting the Fund's lending procedures more fully to the existing state of the international payments system.

4. The wider claims that have been made to the effect that, by enhancing the role of the SDR, a substitution account should move the world monetary system in a direction promising greater stability have little substance. Nor should LDCs necessarily be anxious to place significant fractions of their own reserves in a substitution account.

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Eurodollars and US Bank Lending

5. Those who fear that an IMF substitution account would reduce the availability of international bank credit to LDCs seem to have in mind the following model. There is at any moment a given pool or stock of internationally available funds; substitution arrangements would drain off part of this pool and thus leave less available for lending. The analogy is incorrect however. It is contemplated that the funds drained off will be lent to the US Treasury which will use them to repay existing debt. In the simplest case this will be Treasury bills (or bonds) formerly held by the central bank that now has claims on the substitution account; commercial banking systems will then remain uninvolved. In other cases, the US banking system will find itself (by one route or another) with excess cash reserves. The resulting expansion (or re-expansion) of US bank credit causes US interest rates to ease - which, in conjunction with somewhat firmer rates in the Euromarket, will cause Eurodollar deposits to recover (more or less) to their previous level.

6. There is sometimes a tendency to draw too rigid a line between the Euromarket and the US banking system, with the implication that it is only the former which matters so far as LDC borrowing is concerned. This is far from being the case. Such an approach overlooks the large role in international lending of the US banking system itself.

7. This role (which, of course, was encouraged by the removal of US controls on capital flows at the beginning of 1974) is documented alongside that of the Euromarkets in the Annual Reports and quarterly press releases of the Bank for International Settlements (BIS). In its most recent Annual Report (June 1979), the BIS notes (page 125) that in 1978 the role of US banks was particularly large: external assets of US banks rose by \$36.4 billion, and their net external assets (i.e. external assets minus liabilities) by \$14.5 billion. Excluding the increase in liabilities to foreign official holders - which, in the BIS's words "resulted partly from the expansionary impact of the banks' own external lending activities" - the rise in net external assets came to no less than \$19.4 billion. Most of these funds went into the Eurocurrency market. The external positions of banks in the BIS reporting area (which comprises most of Western Europe plus branches of US banks in certain offshore centres)^{1/} showed in 1978 a net deterioration vis-à-vis the United States of \$16.8 billion - the difference between an increase in liabilities to the United States of \$28 billion and an increase in claims on the United States of \$13.2 billion. In the same period, the reporting banks' net external position

^{1/}See Bank for International Settlements, Annual Report, 1979, page 111. The reporting countries are Austria, Belgium-Luxembourg, Denmark, France, the Federal Republic of Germany, Ireland, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom, together with US bank branches in the Bahamas, Cayman Islands, Panama, Hong Kong and Singapore.

vis-à-vis non-oil LDCs improved by \$8.7 billion (claims went up by \$24.7 billion and liabilities by \$16 billion).

8. The year 1978 may be regarded as somewhat abnormal because of the degree of currency turmoil experienced in its later months, which boosted the demand for dollar credit. But the desire of US banks to compete vigorously for their share of international lending business is a continuing fact.

9. It follows that, if and when dollar deposits are withdrawn from banks by foreign monetary authorities for placement in the Substitution Account, it will make little difference to the outcome whether the banks in question are in the United States or in the Euromarket. And also, that, so long as the US Treasury repurchases debt from the market to match its borrowings through the substitution account, there is probably no need to call on an interest arbitrage mechanism to get the funds back into international markets. US banks could use the spare liquidity generated by US Treasury debt repayments to acquire loans and securities from the US private sector; alternatively, they could acquire additional claims on non-residents. In so far as the dollar balances transferred to the Substitution Account were formerly held not with foreign branches of US banks but with Eurobanks of other nationalities, the main impact may thus be to enhance the position of US banks in international lending, relative to that of their European and other competitors.

10. In the improbable event of the US Treasury not repaying debt but simply keeping the funds on deposit with US commercial banks, some monetary tightening would occur - not in the US banking network, which would have experienced only a reshuffling of deposits - but in the Euromarket. Eurodollar deposits withdrawn for transfer to the substitution account would not have been restored at the end of the day; capacity to lend would have declined. Accordingly, there would be upward pressure on Eurodollar interest rates. Such a shift of dollar deposits from Eurobanks to US domestic banks is, in fact, the only way in which the availability of Eurodollar funds comes to be "spontaneously" reduced. This, however, leads to the more important point of indirect repercussions.

Effect on United States Monetary Policy

11. What is likely to affect the terms and availability of international credit far more than the presence of a Substitution Account is the posture of national monetary policies and of the United States policy in particular. Past experience bears this out. The main periods of stringency in the Euromarkets (such as 1969 and 1974) have been periods of tight credit policy, notably in the United States - just as the intense borrowers' market which developed in 1977-78 owed much to the expansionary tone of US credit policy. How, then, will the substitution account affect US monetary policy?

12. Presumably the Federal Reserve could decide to neutralize the Treasury's repayment of debt by selling off some of its own holdings of open-market paper, which would reduce the cash base of the US banking system. In that sense the Substitution Account may be said to facilitate monetary tightening.

13. There is, however, no reason to suppose that the Substitution Account would increase the inclination to tighten money. On the contrary, one of the US authorities' probable motives in supporting the idea of a substitution account is to assist the management of the dollar by enabling foreign countries to diversify their reserves without upsetting the exchange markets (or, it may be added, the monetary authorities of the Federal Republic of Germany, Japan and Switzerland). Establishment of a Substitution Account will tend to ease the external pressure on the United States to keep interest rates high, and may therefore encourage somewhat greater ease (or less tightening) of US policy than would otherwise occur. Some observers are apparently suspicious of the substitution account for just that reason: it looks too like a mechanism for getting the United States off the hook and helping it to run larger external deficits. Any such effect will be strengthened inasmuch as the United States does not bear the full exchange risk or the full interest cost involved in the change from dollar reserves to SDR claims. Mr. V.B. Kadam in his paper to the Group of Twenty-Four (UNCTAD/MFD/TA/1) is quite correct in observing (in paragraph 27) that "there appears to be no intention to curtail in any manner the present freedom of the United States in arranging its external payments relations" and that "the scheme ... does not contain anything that would in itself encourage appropriate adjustment action by the reserve currency countries..." Mr. Kadam seems to consider this a disadvantage of the substitution account, and so it possibly may be; but as regards liquidity creation through the US balance-of-payments deficit, the implication is that the Euromarket borrowers will find conditions easier, if anything, than they would have done otherwise. Perhaps the prudent expectation, however, would be to look for no change either way in the United States monetary policy.

Other Forms of Diversification

14. It is appropriate here to add a word about diversification of reserves by mechanisms other than the Substitution Account. Exchange reserves in Deutsche Mark, Yen and Swiss francs have expanded considerably in the 1970s, with some offset from a decline in sterling reserves (though the latter may well have been largely reversed by the early months of 1980). If diversification into, say Deutsche Mark involved switching out of reserves formerly held (in any form) in the United States rather than in Eurobanks, the operation will have had an expansionary effect on the Euromarkets. On the other hand, in so far as dollars formerly at US banks wind up being held by the Bundesbank at the Federal Reserve, there will have been a contractionary effect on the US monetary base. But in either case, the relevant monetary authorities will presumably adopt offsetting policy measures as and when they see fit. Similar considerations will apply if there is future diversification into ECU liabilities of the European Monetary

Co-operation Fund or its successor by outside (i.e. non-European) central banks. Although the details naturally differ somewhat from the case of the Substitution Account, the general picture is consistent with the finding that none of these mechanisms have far-reaching effects on the operation of international credit markets.

Official versus private financing

15. Thus far it has been envisaged that the US dollars held in the Substitution Account would be invested in interest-bearing obligations of the United States Government. One should, however, envisage the possibility that, in time, and especially if the Account becomes very large, this provision may be modified to allow the Account to function as a more general intermediary in the provision of external finance. It would then serve as a mechanism for increasing somewhat the role of official institutions in the recycling or balance-of-payments financing process.

16. However, without calling on the Substitution Account, there is already spare lending capacity in the IMF. Its Supplementary Financing Facility of some \$9 billion has so far been scarcely touched. This reflects the weakness of the dollar, but also the reluctance of LDCs to seek additional credit from the Fund. The limited amounts available under LDC quotas and the conditionality of drawings in the higher credit tranches are familiar obstacles here - though they are more readily overcome when additional credit from the Euromarket hinges on IMF approval for the country's policies, which thereby acquires a "gearing" effect.

17. A central issue is that of finding operational criteria for the extension of IMF credit. In the past, it was found appropriate to require repayment of IMF drawings within 3 to 5 years, it being considered that there was no general reason why countries should fail to eliminate a balance-of-payments deficit and regain reserves within this short time span. Matters are different under the OPEC-surplus system, where the oil importers in the aggregate must run a current-account deficit corresponding to OPEC's current surplus. In addition, the pattern of economic growth has shifted within the oil-importing world, with a considerable number of newly-industrializing LDCs maintaining growth at a high rate, while expansion in most OECD countries has slowed down. In these new circumstances, it is not easy to arrive at firm views on the proper terms or conditions for IMF lending. What, for example, are the criteria of balance-of-payments discipline? The adaptation not only of the Fund's financial structure but of its lending practices (for example, to permit longer term or roll-over credits) without surrendering its disciplinary function poses a challenge to those responsible for the Fund's position in the world monetary system.

18. The possibility of creating new institutions should also not be ruled out. If a significant volume of dollars were to be set aside by

the US Treasury as a result of substitution (rather than used for redeeming debt), they could in principle be mobilized for purposes of balance-of-payments lending through official channels.

Wider aspects of the Substitution Account

19. There is no prospect now in view of the world moving towards near-exclusive reliance on SDRs for its international reserves. Moreover, the world is now even less prepared to accept centralized management of international monetary arrangements than it was 30 or 100 years ago. One can certainly see SDR claims and even SDRs created by allocation coming to play a larger role in the monetary system than they do now, but only in conjunction with reserve currencies.

20. By the same token, when deciding whether and on what scale to participate in the Substitution Account, LDCs should consider what specific advantages they might derive from it. I share the mild scepticism discernible in Mr. Kadam's paper, cited earlier, about some of the characteristics of the substitution account and about the likelihood of it contributing either to greater exchange stability or to a much larger role for the SDR in the monetary system. Participation in the substitution account is to be on a voluntary basis; but, at the same time, the intention is to effect a long-term change in the composition of reserves and it is considered that the substitution brought about by the account should in principle be permanent. In other words, it is hoped that reserves deposited in the Substitution Account will effectively be "locked in" and, while freely transferable among member countries, will not be subject (save on liquidation) to reconversion into currency holdings. Given that the essential function of the Substitution Account is to allow countries to change the composition of their reserves, it is somewhat ironic to observe that a participant in the Account will be expected to use its SDR claims only if it has a balance-of-payments need or because of its reserve position or developments in its reserves, and not for the sole purpose of changing the composition of its reserves.

21. The notion of "voluntary" participation thus needs qualifying. Once the Account is in operation, the Fund expects to exercise a degree of control over the composition of countries' reserves, to the extent that those are held as SDR claims. To be sure, SDRs in the Fund Special Drawing Account are already subject to a Fund designation procedure; but this is rather different, since SDRs in the Special Account were created by allocation and not by the deposit of existing exchange reserves.

22. Even disregarding this point, a country may not have much to gain from participation in the Substitution Account, if it has already achieved significant diversification of its reserves into non-dollar currencies. But it may have other reasons for wishing to participate, such as a general strengthening of its relations with the Fund.

INTERNATIONAL MONETARY REFORM:
A SURVEY OF THE OPTIONS

John Williamson*

I. Introduction

The purposes of this paper are to review possible reforms through which a more structured international monetary system might be created to supersede the existing pragmatic arrangements, and to provide a basis for appraising the desirability of these reforms from the standpoint of developing countries.

It is not realistic to consider reviewing all of the conceivable options on every aspect of international monetary arrangements. The general principles that have been used in selecting options for consideration involve concentrating on the strategic issues that largely determine the shape of the system, and neglecting issues of secondary importance and issues that already seem to be settled to general satisfaction.

These considerations led to a decision to analyze the options in four areas. Two of these concern issues that have traditionally been of concern and in which the Committee of Twenty (C-20) elaborated most of the options: the reserve regime, and the exchange-rate system. The third area is that of the international co-ordination of economic policy, which includes the specification of adjustment obligations as discussed under the headings of 'indicators' and 'asset settlement' in the C-20, but in which certain more novel ideas also seem worth exploration. The fourth area involves the possible use of the SDR as a vehicle currency by the private sector: this was not considered at all by the C-20, but is of special interest in the present context inasmuch as it might present an opportunity for giving effect to the principle of collective self-reliance.

The discussion of each topic is organized in the following way. First, there is an enumeration of what are judged, on the basis of the principles sketched above, to be the options worthy of consideration. This is followed by a discussion of the criteria that appear to be relevant to a choice between the various options, and of what those criteria individually imply. Each section is concluded with an appraisal of the trade-offs involved in choosing between the options, and a sketch of the other aspects of reform on which a rational choice might depend. The results of the several appraisals are drawn together in the final section of the paper.

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II. The Reserve Regime

1. Options

One way of limiting the number of options to be considered suggested by the above principles is to assume that the international community will not seek to create new fiduciary reserve assets to supplement or replace the SDR, but will use and develop the latter to the extent that a fiduciary reserve asset is desired. This means, for example, that any elimination of reserve currencies from reserves would be undertaken by substituting SDRs for the assets in question. Furthermore, no consideration is given to the Hart-Kaldor-Tinbergen plan for reserves backed by commodities, which is a proposal that no longer appears to excite much interest. Those restrictions still leave four important 'pure' options for analysis.

(R-1)^{1/} A single reserve currency, which for convenience one may assume to be the dollar.

(R-2) A multiple reserve currency system.

(R-3) A pure gold standard.

(R-4) An SDR system.

An important variant on this option is:

(R-4A) An SDR system embodying the link.

In addition it will be convenient to list the present system and three conceivable variations on it.

(R-5) A mixed system with the dollar as the dominant reserve currency, a number of secondary reserve currencies, SDRs and SDR-denominated assets like Reserve Positions in the Fund, and, at least nominally, gold.

(R-5A) A mixed system with a prohibition on the holding of reserves in offshore markets.

(R-5B) A mixed system with a voluntary one-way substitution facility.

(R-5C) A mixed system with an agreement by central banks that they would accept gold in settlement of payments imbalances at a price close to the ruling market price.

2. Criteria for Evaluation

The classification scheme previously used in a survey article on international liquidity by the present author ^{2/} seems to have been

found useful, and will therefore be employed to organize the discussion of the present section.

(a) The Confidence Problem

This refers to the problems of instability that can arise when a widespread loss of confidence in a reserve asset creates a general desire on the part of holders to shift their funds out of the suspect asset. The attempt to shift out will itself further weaken the suspect asset. In a system where the relative values of the different reserve assets are fixed, there is no automatic mechanism to limit such a run, which can therefore place unbearable strains on the reserve centre, and may alter the total volume of liquidity and cause the renunciation of previous obligations. In a system where the relative values of different reserve assets can vary in response to market forces, such as the present one, these variations can themselves go far enough to eliminate the desire to switch. However, experience since 1973 seems to suggest that these movements sometimes have to go much further than would be needed to secure payments adjustment in order to restore a willingness to hold the outstanding stocks of the several assets. This implies that the instabilities caused by shifts in confidence are merely changed in form, rather than eliminated, by the adoption of floating exchange rates; in particular, the total real value of reserve holdings is still vulnerable to confidence effects.

The most obvious solution to the confidence problem is to adopt a reserve regime with a single reserve asset, such as the dollar, gold, or the SDR. The problem with this solution is essentially the difficulty of securing general acceptance of a self-denying ordinance by which countries would agree to hold only one reserve asset, and of ensuring that they abided by that commitment even when diversification appeared financially advantageous. A commitment to this effect would, however, be essential if adoption of a single reserve asset were to bring a solution to the confidence problem. It is probably realistic to recognize that no commitment could be sufficiently firm to give assurance that it would continue to be observed if the incentive to switch were repeatedly, let alone continuously, large; this implies that any successful reserve asset, even one without legal competitors, must offer a competitive rate of return to holders.

Another possible solution to the confidence problem is an agreement to freeze the composition of reserves. Ideally this solution would involve each country accepting the same reserve composition, so as to prevent payments imbalances leading to shifts in the composition of aggregate reserves. The difficulty with this solution is essentially the same as with the previous one; it not only requires an agreement by countries to restrict their freedom of action, but it requires that they continue to observe that undertaking when this conflicts with their short run national interests in a rather obvious way.

A third possible solution is for the issuer of a reserve asset to give exchange guarantees. The problem with this solution is that it is not in general attractive to the issuer. In order to reassure the holder, an exchange guarantee has to be expressed in a stronger asset than that of the issuer; but this means that the expected cost of servicing guaranteed debt is higher than that of servicing debt denominated in the stronger asset so long as the (higher) weak-currency interest rate is paid - and if the strong-asset interest rate is paid, the proposal amounts to substitution rather than the provision of an exchange guarantee.

The fourth possible solution is substitution. Either the issuer directly, or a substitution facility acting on his behalf, can stand ready to accept debt denominated in the suspect asset from the holder, and in its place to issue new debt denominated in a different asset. In this way the holder gets a change in the composition of its assets without the issuer having its liquidity position undermined. Substitution generally seems to pose a delicate problem regarding the maintenance of a balance between the interest of issuers and holders, presumably because the question generally arises when a long-standing debtor-creditor relationship is in the process of breaking down. In this situation it is perhaps natural for the issuer to assume that the terms on which it borrows should become in no way more onerous as a result of substitution; whereas the reason that substitution is under consideration at all is precisely because the holder has come to find the issuer's existing terms unattractive, and is therefore seeking something better in at least certain respects. Similarly, the denial of any right to 'undo' substitution would pose the same policing problem as the single-asset solution, but unlimited opportunities to shift could easily offer the holder opportunities to profit at the expense of the issuer that the latter would surely find unacceptable. This is not to argue that feasible compromise solutions can never be found where the will and ingenuity are present, but it does perhaps suggest why attempts to negotiate substitution proposals of even the most modest kind have encountered major difficulties.

(b) Stabilization

During the 1960s and early 1970s, there would probably have been a consensus that the prime criterion by which a reserve regime (like a monetary system) should be judged was its contribution to stabilization. It was argued that this involved three desiderata: contra-cyclical operation, provision for an optimum long-run rate of monetary growth, and the avoidance of the types of monetary shocks that have in the past generated major inflations or slumps. However, views as to the extent to which reserve supply policy can contribute, positively or negatively, to stabilization have been revised sharply in the last few years. It is now widely accepted that the supply of reserves is highly elastic, as a joint result of the development of capital mobility and the adoption of floating exchange rates between the major currencies. It is furthermore argued that under floating the supply of reserves no longer has the strategic role in determining the pace of world monetary expansion that it did under the gold standard

and was assumed to have largely retained under the Bretton Woods system, principally because the much greater degree of exchange-rate flexibility (even on the part of countries practicing some form of pegging) means that the link between reserves and money supplies has now been effectively broken. ^{3/} In consequence, there is now much less belief than there was in the early 1970s that it will be possible to establish control over the supply of reserves, but there is also much less conviction that simply controlling the supply of reserves could contribute significantly to stabilization policy.

Of the three ways in which a monetary system can contribute to stabilization, there seems little hope of introducing any contra-cyclical influence without both a move to a more viscous ^{4/} exchange-rate system and the introduction of a reserve regime in which the quantity of reserves was subject to deliberate control. The latter could be accomplished either by a dollar standard, in which case the control would be exercised by the Federal Reserve, or by an SDR standard, in which case control would be exercised through the IMF.

So far as the question of the ability to generate an adequate long-run growth rate of reserves is concerned, all of the systems except the gold standard seem perfectly acceptable. Furthermore, so long as the system retains its present characteristics of exchange-rate flexibility and capital mobility, neither does there seem much reason to fear excessive reserve growth - with one exception. That exception concerns ad hoc gold remonetization (R-5C), under which central banks would agree to accept gold at a price close to its current market value; such an agreement would make the value of reserves dependent on a market-determined gold price, which tends to go up when fears of inflation mount, and would thus be likely to generate excessive reserve growth at the worst possible time. If reform were to result in much greater viscosity of exchange rates and reduced capital mobility, then deliberate control of liquidity would again become of importance from this standpoint as well. This would point to either a dollar standard or an SDR standard.

Finally, the avoidance of monetary shocks is essentially the same thing as solving the confidence problem, which has already been considered in the previous section.

(c) Financial Implications

A consequence of the creation of reserves is that the issuer is able to import real resources or extend loans without having to draw down its liquid assets. Under certain circumstances this ability provides a financial advantage to the issuer. The critical condition for such a gain to exist is that the rate of interest that the issuer has to pay on the reserves that it issues is less than the rate at which it can invest abroad and/or which it would have to pay to borrow abroad at similar maturity. Although all these rates might be equal in a 'perfect' capital market, in reality they are not; most developing

countries would undoubtedly have to pay substantially higher interest rates than a competitive SDR interest rate in order to borrow at comparable long term on their own security. It follows that there are indeed financial benefits at stake in the matter of reserve supply (as developing countries long ago recognized when they decided to press for the link).

A 'competitive interest rate' can be defined as one high enough to make the asset in question as attractive to holders as competing assets. Restrictions on the manner in which reserves can be held may enable the issuer to pay lower interest rates, which is advantageous to the issuer but detrimental to the holders. Holders therefore have an interest either in ensuring freedom of reserve composition, or in guaranteeing that any restrictions on that freedom do not lead to a reduction in the average return they can expect below the competitive rate.

How do the various systems compare as regards the financial benefits that they promise to developing countries? A pure dollar system without reserve placements in the offshore markets would tend to concentrate all of the benefits on the United States, and might even lead to a sub-competitive interest rate and therefore a further benefit to the United States at the cost of the rest of the world, including developing countries. A multiple reserve currency system would tend to eliminate the latter danger, but the generalization of the benefits of issuing reserves would scarcely be likely to include any (let alone all) developing countries. Either a pure gold standard or gold remonetization would give the benefits to gold producers and major gold holders; although there are a few developing countries in these categories, both proposals would be severely detrimental to developing countries collectively. Present arrangements are slightly better, since there are two ways in which developing countries are able to gain a small part of the financial benefits: first, through their share in SDR allocations; and, second, through the operation of the offshore markets. (The argument here is that, because a part of reserve holdings are deposited in the Euromarkets, those markets are able to lend more than would otherwise be the case; that developing countries are important borrowers in those markets; and therefore that they can borrow rather more and/or borrow at rather lower interest rates than would otherwise be possible. Many economists, however, now argue that arbitrage between the national and offshore markets is sufficiently perfect to make this effect quantitatively modest.) Addition of a substitution facility would provide some long-term financial benefits to developing countries, if the balances in the facility were eventually amortized and new SDRs were allocated to neutralize the reserve destruction that amortization would otherwise cause. This process would presumably be taken further, and more quickly, if the SDR were to be made the unique reserve asset. This is the solution that would promise the largest financial gains to developing countries even in the absence of a link, and the comparison would be even more favourable to the SDR system if a link were to be established.

With an SDR system, especially with a link, developing countries

as a group could expect to be net beneficiaries of a sub-competitive interest rate, and therefore of strong rules limiting freedom of reserve composition. However, certain developing countries, notably the low-absorbing oil exporters who can expect to be major net creditors for the indefinite future, would be heavily penalized by this solution. This is a particularly graphic illustration of the fact that LDC interests are not monolithic.

3. Appraisal

The preceding analysis suggests that four of the options can be dismissed as unambiguously less favourable to developing countries than existing arrangements. The first of these (R-5A) would involve prohibition on the placement of reserves in the Euromarkets, which could be expected to cause financial losses (albeit of modest size) without bringing any offsetting benefits. Two more - (R-5C), ad hoc gold remonetization as proposed by Prime Minister Barre, and (R-3), a pure gold standard - would involve a massive redistribution of income and wealth away from the developing countries as a group (even though a few individual countries might gain), to the extent that formal gold remonetization led to a further rise in the gold price. Finally (R-2), the formal establishment of a multiple reserve currency system, would again deprive developing countries of such financial benefits as they can derive from the present system, while tending to worsen rather than ease the confidence problem. On the other hand, there is no persuasive reason for believing that a continued evolution of the present system toward a multiple reserve currency system would be harmful to developing countries, so long as the process does not squeeze out the SDR or threaten the offshore markets.

This evolution does not, however, promise any gains to developing countries: it will neither solve the confidence problem, create a reserve system that can contribute to stabilization, nor bring any financial gains beyond those offered by the present system, including the right to choose reserve composition freely. Assume for the moment that it is decided that it is either not necessary, not possible, or not worthwhile to seek to pursue the stabilization objective through the reserve system, except negatively by solving the confidence problem, and consider what options the limited remaining objectives would suggest. The simplest step would be the addition of a voluntary substitution facility to existing arrangements (R-5B), which would both be helpful to the confidence problem and might bring some financial benefits in the long run, at the cost of additional restraints on the freedom of reserve composition that would presumably be rather modest. A far more ambitious step would be adoption of an SDR system (R-4): this could solve the confidence problem, and would also give developing countries a share of the benefits of reserve creation at least $\frac{5}{9}$ equal to their share in IMF quotas. The cost would be renunciation of the freedom of reserve composition, which one would expect to be an acceptable cost to prospective creditor countries (including especially low-absorbing oil exporters) only if there were a guarantee that the SDR would on average pay a competitive interest rate. The benefits of an SDR system to developing countries would be further enhanced by

adoption of the link (R-4A). (It can also be noted that the confidence problem could equally well be solved by adoption of a dollar system (R-1), but since this would involve the same constraints on reserve composition as the SDR system while lacking the financial attractions of the latter, one can presumably dismiss this option.)

Consider finally how these conclusions would be changed if other aspects of the reform, to be considered subsequently, should lead to a situation in which there was reason to suppose that stabilization could be effectively promoted by control of the aggregate reserve stock. (The conditions for this are essentially a viscous exchange-rate system and a drastic reduction in capital mobility.) This would create an additional, perhaps rather strong, reason for preferring one of the two solutions in which deliberate control of the reserve stock would be possible, i.e., a dollar standard or an SDR standard. The reasons for preferring the latter option would remain valid, and would indeed be reinforced by consideration of the political implications for the location of control of the global reserve stock, which would be based in the IMF under an SDR standard and in the Federal Reserve Board under a dollar standard.

III. The SDR as Vehicle Currency

1. Options

The SDR was introduced as a reserve asset to be held exclusively by the official sector. Such perfunctory consideration as the C-20 gave to the matter favoured retaining this state of affairs, on the ground that private holding of SDRs could lead to destabilizing variations in the volume of official reserves. Given the present more relaxed attitude to the control of international liquidity, the logic of which has already been explained, this reason is now less likely to be viewed as decisive than it was in 1973. Hence it is worth exploring whether, as has sometimes been urged ^{6/}, an attempt should be made to develop the SDR as a vehicle currency to perform the functions of 'international money' at the private level. Two options will be considered: a first in which all countries agree to encourage or require the use of the SDR in their international transactions, the second in which this step is taken solely by the developing countries, in the name of collective self-reliance.

- (V-1) All IMF member countries agree that they will peg to and intervene in the SDR, and that they will permit/encourage/require their residents to denominate new assets, liabilities and contracts either in their domestic currency or the SDR. The IMF would make arrangements to support such a move, including:

- (a) the acceptance of SDR deposits from commercial banks and the provision of clearing facilities in SDRs;

- (b) the provision of lender-of-last-resort facilities to commercial banks operating in SDRs;
- (c) an amendment to the practices presently used to value the SDR, so that an agreed set of parities between the currencies in the basket plus the weight of each currency would jointly determine the par values of those currencies, while actual transactions values could deviate from those par values within the margins in accordance with supply and demand.

(V-2) All developing countries agree that they will peg to and intervene in the SDR, and that they will require their residents to denominate new assets, liabilities and contracts either in their domestic currency or the SDR.

Either of these proposals would involve a revolutionary change in the working practices of international finance. Transactions involving parties in more than one country would come to use an international asset, in place of a national currency, for denominating debts and effecting payments (i.e., as the vehicle currency). The issues involved in making a transition to such arrangements are sufficiently novel to merit an extended discussion.

Consider first an agreed worldwide move to adopt the SDR (V-1). It is convenient to start by considering a technical aspect of some complexity, concerning the valuation of the SDR. At present the SDR is valued as a basket of the sixteen principal trading currencies, with the weights representing the importance of each currency in trade and reserves. A large part of the logic of adopting the SDR as vehicle currency would be to allow international transactions to be denominated in a unit which, by virtue of this definition, cannot fluctuate significantly in terms of the currencies of the principal countries collectively. Hence it would be counterproductive to abandon the existing valuation principle. On the other hand, the present practice involves market exchange rates determining precise values at which each currency trades against the SDR, whereas for the SDR to be used as intervention medium there is a need for the SDR/currency rate to be able to move within the margins. The solution suggested in (V-1c) is to retain the present basket method so far as the determination of par values is concerned, and then to allow fluctuations around those par values in accord with supply and demand. Obviously this solution presupposes a general return to a par value system, in which it is natural to suppose that all currencies would be pegged to the SDR.

What are the conditions that would be necessary to induce the private sector to adopt the SDR? Obviously the minimum condition would be for governments to be willing to permit their citizens to use the SDR in international contracts. At the other extreme, it would be possible to legislate use of the SDR in all international transactions: this would be achieved if all countries limited their

own citizens to signing contracts denominated in either their national currency or the SDR - since then the only common medium for use in transactions between the residents of different countries would be the SDR. In between, it would be possible to encourage the use of the SDR. It is not clear that mere encouragement would suffice to establish the SDR, given the well-known sentiment of markets in favour of established currencies and their suspicions about new 'artificial' units, especially in view of the 'infant currency' problem posed by the fact that by the very nature of its function a medium of exchange becomes useful only once it wins widespread acceptance. Nevertheless, it is instructive to analyze the steps that governments could take, short of compulsion, to create the conditions in which the private sector would want to hold and use SDRs.

One step that governments could take to that end would be to conduct their own international transactions in SDRs. If, for example, oil prices were denominated in SDRs, and payments to oil-exporting countries had to be made in SDRs, that in itself would create both a need for the oil companies to build up SDR deposits in advance of their payments becoming due, and a desire by OPEC to hold SDR deposits afterwards at least up to the time when more permanent investments were effected. Banks that came to acquire these SDR deposits would have an incentive to use these funds to make short-term SDR loans. Similarly, if central banks were to adopt the SDR as the intervention medium, that would provide an incentive to commercial banks and other lenders to hold SDR deposits in order to be able to reap the arbitrage profits that are at times available through transactions with the intervening authority. With whom would commercial banks hold SDR deposits? With the IMF, surely, which could provide the basic infrastructure services that a banking system needs - a lender of last resort, a holder of working balances, and a provider of clearing facilities.

A useful way of clarifying one's thoughts about proposals for monetary reform is often to spell out what is implied in terms of a set of T-accounts. This is done below, for the straightforward case where the SDR supplants rather than merely supplements national currencies at the international level. The IMF's accounts are presented as those of a normally-constituted bank, with its assets consisting of claims on its members (e.g., the implicit claims that form the counterpart to SDR allocations, or those arising from substitution), and its liabilities consisting of the SDR reserves held by central banks (R_1) and by offshore commercial banks, or Eurobanks (R_2). The collective balance sheet of all the central banks shows their assets as their international reserves consisting of their SDR holdings R_1 , plus (the central-bank component of) domestic credit. Their liabilities consist of high-powered (or base) money, plus IMF claims; the presence of the latter emphasizes that SDR allocations do not lead directly to monetary expansion. The Eurobanks have a (presumably small) part of their portfolio in deposits held as working balances at the IMF, and the rest in (SDR-denominated) loans, while their liabilities consist of (SDR-denominated) deposits. Commercial banks continue to operate in national currencies. (To the extent that they accept SDR deposits, make SDR loans, or hold SDRs for international transactions, they may be classified as part of the Eurobank system.)

<u>IMF</u>	
A	L
Claims on members (C)	Official reserves (R_1) Eurobank reserves (R_2)

<u>Central Banks</u>	
A	L
R_1 Central bank credit	High-powered money (H) C

<u>Eurobanks</u>		<u>Commercial Banks</u>	
A	L	A	L
R_2 Loans	Deposits	H Securities Loans	Deposits

The preceding T-accounts are helpful in understanding how the initial transition to an SDR system could be made. The essential change needed to move to a system in which the SDR fulfilled the vehicle-currency role would be to shift the Eurobanks to an SDR basis; as a corollary, the Eurobanks would close down their New York accounts and transfer their working balances to the IMF (R_2). So long as the desire to switch denomination remained roughly equal on both sides of the Eurobanks' balance sheets, there would be no problem. A bank that confronted simultaneous requests by depositors to convert \$1 m into SDR deposits and by borrowers to redenominate \$1 m loans into SDR loans could simply make the necessary bookkeeping adjustments, without exposing itself to exchange risk. Suppose, however, that the desire to switch into SDRs were greater on the part of depositors than of borrowers. The Eurobanks could then maintain a covered portion by either (a) calling in loans and building up their SDR deposits at the IMF (a form of substitution, in which the IMF would acquire claims on certain central banks), or (b) calling in that part of their loans corresponding to the currencies in the SDR basket other than that in which their deposits were previously denominated, and switching these sums over the exchanges into the other currencies in the basket, for investment in assets denominated in those currencies. The latter alternative would create pressures in the exchange markets, and the banks might confront problems in finding suitable investment media in some of the small-country currencies in the SDR basket. It might therefore be desirable to prohibit this second course of action, which could be accomplished by requiring that the banks hold balanced (not merely covered) SDR positions. This would force the banks into the first alternative, which would create downward pressure on the (relative) SDR interest rate, hence encourage a switch into SDR-denominated borrowing; thus the market would set up pressures for balanced switching into SDRs.

So much for description of (V-1). The technical obstacles are not really all that great, but its adoption would require two decisive changes of attitude on the part of the major developed countries: (a) a

willingness to return to a par value system, and (b) a willingness to see the international roles of their currencies ended, including an acceptance of indebtedness in SDRs. (It is of course the refusal of the United States to contemplate this possibility that lay behind the failure of the proposal for a Substitution Account in 1979-80.)

The second proposal (V-2) is intended to suggest that it would be possible for the developing countries acting collectively, but independently of the developed countries, to adopt the SDR as a vehicle currency. In two important respects such a move would in fact be simpler than the general shift considered previously. First, since the countries pegging to the SDR would not dominate the composition of the SDR, there would be no need to amend the definition of the SDR. Second, as a corollary, there would be no need for the major developed countries to abandon floating.

In other respects, however, a unilateral-collective move by the developing countries would be more difficult, especially if the IMF did not provide banking infrastructure services (acceptance of deposits for working balances, clearing facilities, and lender of last resort) for the offshore SDR market. In that event the Eurobanks would have to organize a clearing house for themselves, to arrange to hold working balances between themselves, and to cope without a lender of last resort prepared to lend SDRs. There is no reason to think that the banks could not organize a market of this sort for themselves, if they had the incentive to do so. It is to ensure that they would have such an incentive that the proposal (V-2) speaks of all developing countries requiring their residents to undertake all international transactions in SDRs. The developing countries are now collectively quite a large enough market to give individual traders and banks in the developed countries an incentive to innovate in order to keep their custom.

Once a significant part of the Euromarkets were SDR-denominated, any central bank that itself held call deposits in SDRs would be able to intervene in SDRs to defend a peg defined in the SDR. The developing countries would therefore be on an SDR-based system.

To conform with the practice in other sections, the maintenance of present arrangements may be listed as a third option.

- (V-3) The SDR will remain exclusively an official asset, with no effort being made either to encourage or to impede its adoption as a unit of account by the private sector.

2. Criteria for Evaluation

(a) Promotion of the SDR

One of the principal objectives articulated by the Committee of Twenty was that of placing the SDR at the centre of the international monetary system. Developing countries have taken the view that such a

development would be very much to their advantage - in part because of the expectation that such an evolution would also establish the SDR as the basic or even the unique reserve asset, and thus bring the advantages examined in the preceding section of this paper; and in part because an SDR system would place management of the international monetary system in the hands of the whole international community, of which they constitute an influential part, rather than in the hands of one or a few industrial countries. These would be important advantages of (V-1), and might also to some extent be promoted by (V-2).

(b) Reduction of Exchange Risk

One of the frequently-voiced complaints of the developing countries against the existing system of generalized floating is the additional measure of uncertainty with which it confronts them. For example, a depreciation of the dollar reduces the purchasing power of oil exporters, at least until such time as the oil price is adjusted; it increases the competitiveness of an exporter of manufactures in a country whose currency is pegged to the dollar in non-dollar markets; it reduces the purchasing power of primary commodity exports that have already been contracted to be sold at a fixed dollar price; it increases the dollar reserves needed to service a non-dollar debt; and so on, without the slightest reason to suppose that these changes have any rationale in terms of the needs of the countries concerned. These uncertainties could be largely eliminated by adoption of the SDR, defined as at present as a basket of the principal currencies, as a vehicle currency - even if that adoption were confined to the developing countries, as under (V-2). (However, to the extent that fluctuating exchange rates between the currencies of the developed countries are disliked not because of the uncertainties they directly impose on the developing countries, but because they are believed to harm the economic performance of the developed countries themselves and thus to reduce their demand for imports from the developing countries, the proposal would be largely irrelevant.)

Clearly the proposal would not eliminate exchange risk, but transfer it from the developing countries to the developed countries who form their principal trading and financial partners. It needs to be asked whether this would necessarily be advantageous to the developing countries: might it not be that the developed countries would in effect charge 'insurance premiums' so large as to leave the developing countries no better off? There are in fact reasons why this seems unlikely. The basic point is that the change would result in a net reduction in risk, and not simply in its redistribution. Some examples may be given to illustrate this point. (1) Consider a German exporter selling to a former dollar-pegging developing country who previously invoiced in DM. It is true that he would face a new source of risk, as a result of fluctuations in the DM/SDR rate. However, his importing trade partner (in the developing country) would be relieved of exchange risk - and his gain would be greater than the exporter's loss because DM/dollar fluctuations are typically larger than DM/SDR fluctuations (as a result of the fact that the SDR is a basket). (2) Each trader in the non-SDR pegging area would depend on only one rate

with respect to his trade with the developing world - the rate between his own currency and the SDR. It would be relatively easy for him to maintain an informed judgment on likely movements of that rate. In addition, one can be confident that active forward markets would quickly emerge between the SDR and the currencies of the principal industrial countries (even under V-2). In contrast, at present any trader in a developing country has to watch a dozen different rates and cover forward in a dozen different markets (if they exist at all) to get comparable protection.

If the basket SDR could provide a vehicle currency with such attractive properties, it is natural to wonder whether its benefits should be restricted to the developing countries. Does this not also provide an argument for (V-1)? The answer is no, and the reason is that use of the SDR as vehicle currency by the countries whose currencies compose the basket would require return to a par value system (as argued above). The paradox is that, if a system of par values is operating, then the additional reduction in exchange risk that would result from adoption of the SDR as vehicle currency would be rather modest.

(c) Stabilization of Exchange Rates

In contrast to the immediately preceding argument, this rationale for adoption of the SDR as vehicle currency applies principally to (V-1) rather than to (V-2). The rationale consists of the fact that an SDR serving as vehicle currency would facilitate exchange-rate stabilization between the major currencies.

The major way this would occur is through a reduction of speculative pressures on third parties. Under present arrangements, speculation against the dollar has to be conducted by switching into some other national currency, which in practice tends to mean into the strongest currencies with well-developed financial markets, like the DM and Swiss franc. That differential pressure on non-dollar currencies can make it difficult for them to maintain pegged exchange rates among themselves. In contrast, with the SDR serving as vehicle currency, speculation against the dollar might take the form principally of a move from the dollar into the SDR, which would avoid such differential pressures on third countries. It cannot be taken for granted that this would completely eliminate the problem, inasmuch as a devaluation of the dollar against a basket SDR implies a revaluation of the other currencies in the basket against the SDR, so that some incentive to move on from the SDR to the DM (and other particular currencies) would persist. Nevertheless, the problem might be substantially eased, for two reasons. First, the DM/SDR change (and therefore the incentive to move into the DM) would be much smaller than the DM/dollar change (which is what motivates shifts under present arrangements). Second, it might be easier to maintain effective exchange controls without threatening the beneficial effects of capital mobility with the SDR as vehicle currency, since residents in each country could be forbidden to hold the national currencies of other countries; and such controls, if

effective, would serve to prevent a flight from the dollar moving on into the DM.

The second form that such support might take is really a generalization to the private level of the ideas that Triffin developed to explain the inherent fragility of the gold-exchange standard at the official level. 7/ International investors prefer to place their funds in strong currencies. International borrowers have to borrow in those currencies because it is only in those currencies that financial intermediaries have funds available to lend, but they borrow with a certain reluctance. The net result is to push up, or to sustain above its purchasing power parity, the value of a currency acquiring a vehicle-currency role in respect to capital movements (for example the dollar in the 1960s, and perhaps the Swiss franc in the 1970s). Sooner or later this leads to a current account deficit, pressures for depreciation, and then an exaggerated depreciation as investor confidence is shaken while borrowing is stimulated. This cycle could presumably be broken by the concentration of international borrowing and lending in terms of an international asset whose value was immune to the payments positions of individual countries.

3. Appraisal

The case for promoting the SDR as a vehicle currency is therefore very different depending on whether or not the developed countries move back to a par value system. Should that occur, the move could be usefully reinforced by a general adoption of the SDR as vehicle currency on the lines of (V-1). In the absence of any such move, the proposal would not be feasible for the system as a whole, but a unilateral collective move by the developing countries on the lines of (V-2) would provide a way for the developing countries to protect themselves against the direct consequences of exchange-rate instability within the OECD area. Either move, though especially the general one, would go a long way toward achieving the objective of establishing the SDR at the centre of the international monetary system.

The difficulties of adopting the SDR as vehicle currency would also be very different as between the two versions of the proposal. A general move would be dependent upon reversion to a par value system and renunciation of an international role for their currencies on the part of the major financial powers. A move limited to the developing countries would require the participation of them all in order to create an incentive for the Eurobanks to provide the necessary facilities; such a move would be greatly aided if the IMF furnished supporting infrastructure services. The infant currency problem implies that in both cases progress will demand a big bold step; gradualism will lead nowhere.

IV. The Exchange-Rate System

1. Options

There seems little point in including among the options either of

the textbook exchange-rate regimes, of free floating (in which central banks are committed not to intervene in the exchange market) or permanently-fixed exchange rates. No government has indicated any willingness to consider free floating, at least in recent years, and the experiences reviewed below do not suggest that this has been a serious oversight. It is also quite clear that permanently-fixed exchange rates, with their requirement for a virtually complete renunciation of monetary sovereignty, are not a serious option for the ordering of exchange-rate relationships on a worldwide basis. What remain for consideration are therefore the three intermediate exchange-rate regimes, plus the existing *laissez faire* arrangements.

- (X-1) Managed Floating. 8/ This is characterised by the central bank retaining the right to intervene in the exchange market, but without accepting any obligation to maintain the rate within any band.

Two proposed codifications of when intervention should be undertaken (over and above short-term smoothing) deserve mention:

- (X-1A) Leaning Against the Wind. The central bank is expected to buy reserves when its currency is appreciating and to sell them when it is depreciating.

- (X-1B) Target Zones. 9/ The central bank is expected to buy reserves when its currency is appreciated above some target zone, and to sell them when its currency is depreciated below this target zone.

- (X-2) The Adjustable Peg (or 'stable but adjustable par values'). This is characterised by each currency having a par value (or 'peg'), and its central bank accepting a commitment to maintain its exchange rate within a specified band around that peg until further notice. There is no a priori restriction on the size of the change in the peg that can be made when change is regarded as desirable.

- (X-3) The Crawling Peg. This system again involves each currency having a peg, and each central bank accepting a commitment to defend a band around that peg. In addition, it involves a commitment to limit each individual change in the peg to a 'small' size. (There is no natural criterion to define what is 'small' in this context, but the intention is to ensure that exchange rate changes are gradual rather than abrupt.)

- (X-4) *Laissez-faire*; each country is permitted to choose its own exchange arrangements, as under the Second Amendment.

Present arrangements involve a mixture of virtually all conceivable regimes except free floating. The major industrial countries, except those in the European Monetary System, are on a managed float, along with a few other countries. Exchange rate management is largely *ad hoc*, with some leaning against the wind, some resort to what may be termed an 'unannounced, adjustable-under-pressure peg', and some implicit but unannounced and uncoded use of target zones. A majority of non-industrial countries still utilize the adjustable peg, as under the Bretton Woods system. The European Monetary System is also ostensibly on the adjustable peg, although it and in recent years its predecessor, the snake, have tended to operate more like a crawling peg in that individual realignments have been small. Six countries, five of them South American semi-industrialized countries, use the crawling peg, and about a dozen small countries, principally in the Caribbean and Central America, have fixed exchange rates.

Many developing countries feel that it is inappropriate for exchange-rate obligations to apply with equal force to them as to the major developed countries at the centre of the system. They argue that the lack of an international role for their currencies implies that the spillover effects on other countries of their actions are negligible, and therefore that there is no case for international constraints on their freedom of action. This is not inconsistent with the view that some of them (especially those with relatively free capital flows) may find it advantageous to limit their own freedom of action, so as (for example) to reassure potential speculators. It does, however, imply that the following discussion should be interpreted as applying principally to the choice of an exchange-rate system for the developed countries.

2. Criteria for Evaluation

Discussion of the comparative merits of alternative exchange-rate regimes has traditionally involved a number of rather ill-defined, overlapping considerations, which have not as yet been authoritatively systematized in an agreed classification scheme. The following discussion has been organized around five topics that have clearly been deemed important by many writers.

(a) Exchange-Rate Stability

It is widely agreed that erratic and large fluctuations in exchange rates are undesirable: they can be expected to act as a deterrent to trade, ^{10/} there is a presumption that a change that is expected to be permanent but is in fact reversed will lead to wasteful resource reallocations, there is an analogous presumption that where a change needs to be permanent in the interest of securing payments adjustment the necessary resource reallocation is less likely to be forthcoming in an environment dominated by temporary fluctuations, and there seems to be a widespread belief (not as yet substantiated by hard

evidence) that exchange-rate instability harms business confidence and thereby tends to sap investment. There may be less agreement about the exact concept of exchange-rate stability that would be desirable. Is stability of the 'effective' exchange rate (i.e., the average exchange rate, weighted by the importance of other countries as trade partners and competitors) sufficient, or is stability in bilateral rates also important? Is stability of the nominal exchange rate or the 'real' exchange rate (the nominal rate corrected for inflation at home and abroad) the more important? Some would argue that the most important concept of stability involves the set of bilateral real exchange rates, since it is these that determine the profitability of trade and the incentives for resource reallocation. However, it can certainly also be argued that the effective real rate is important, from the standpoint of adjustment; and also that the nominal rate is significant, from the standpoint of price stabilization.

There is no doubt that, on any concept, exchange-rate instability has increased substantially since the advent of managed floating between the major currencies. Movements in nominal exchange rates between these currencies have been large and have often been reversed rather than simply serving to neutralize differential inflation rates, so that real rates have fluctuated significantly (fluctuated, and not just adjusted as needed to promote payments adjustment). The large fluctuations between the major currencies have inevitably resulted in equally large fluctuations in most bilateral exchange rates of developing countries, whatever exchange-rate policy these have themselves adopted.

The historical evidence therefore justifies a strong presumption that managed floating, and the present mixed system of which it is such an important part, involve substantially greater costs in terms of exchange-rate instability than the adjustable peg that preceded present arrangements. Supporters of floating might reply in a number of ways. First, they might attribute the instability to the attempts to manage rates instead of allowing free floating. Such evidence as is available does not seem to support this position, 11/ which is also at odds with several rather conspicuous examples of exaggerated depreciations that were only reversed by vigorous programmes to defend the rate (e.g. Italy and UK in 1976, or the USA in 1978). Second, they might again argue (as they did periodically in the years 1974-1977) that these large fluctuations represent a transitional learning phase in the move to floating, and that rates will become more stable as market operators become more familiar with the new system and/or as governments adopt more stable monetary policies. Perhaps one day these recurring optimistic claims will be vindicated, but the analysis in section (d) below provides little reason for optimism on this score. Third, it may be argued that rates could be stabilized by more systematic intervention policies, such as 'leaning against the wind' or a general use of 'target zones' or 'reference rates'. Although there is not at present much evidence with which to back up such claims, a reasonably persuasive case can be made that such policies (especially, in the author's view, agreement on and publication of an internationally-agreed set of target rates that would be used as a guide to intervention policy, as in the 'reference rate proposal 12/) might help to reduce instability.

Be that as it may, there can be no denying that a set of target zones could be more effective in preventing rates deviating from them if they were backed up by a commitment to intervene to prevent such deviations, i.e. by abandoning floating in favour of a return to a system of pegged rates. A question that then arises is that of the relative merits of the two pegged-rate options under analysis, namely, the adjustable peg and the crawling peg. This comparison is sensitive to the particular concept of stability that is judged to be of importance as well as to the particular policy that is adopted to guide parity changes. A belief that frequent par value changes are more disturbing than large changes (for a given total size of change over a given period) would tend to argue for the adjustable peg, and vice versa. A belief that stability of the real exchange rate (i.e., constancy of the competitiveness of export and import-competing industries) is more important than stability of the nominal rate argues in favour of the crawling peg, since this can be (and indeed has been, as in Brazil and Colombia) used with the deliberate objective of stabilizing the real exchange rate. The real rate stabilized has usually been that against a single other country, i.e. the bilateral rate with the country's principal trading partner, in practice the United States; but obviously there is no reason why policy should not be chosen with a view to stabilizing the average ('effective') real rate. It is worth noting that if all countries adopted a policy of stabilizing their effective real rates, this would also stabilize all bilateral real rates as well. The problem of capriciously-varying competitiveness suffered by the developing countries since the advent of managed floating would be resolved.

(b) Speculation

As long ago as 1953, an observer sympathetic to the adjustable peg remarked that speculation was its 'recognized weakness'. ^{13/} Since then, the international capital market that was dormant in the early post-war years has been reborn and grown dramatically, and as a result capital mobility has grown many times over (and considerably faster than other economic magnitudes). ^{14/} One of the consequences was to accentuate the 'recognized weakness' of the adjustable peg, which was plagued by a series of ever-larger speculative runs in its later years whenever a major currency was regarded as a devaluation or revaluation candidate. By 1973, capital could flow into the DM at a rate of \$1 billion per hour or over \$2 billions per day. The problem was recognized to be so acute that the C-20 created a Technical Group specifically devoted to the study of disequilibrating capital movements.

These flows have a straightforward explanation. A shift into a revaluing currency, or out of a devaluing currency, shortly before a step change in its par value provides a high rate of return for minimal expense or risk, while requiring that funds be committed for a minimal length of time. Where international capital flows are not illegal, it is to be expected that an increasing proportion of asset holders will learn to take advantage of such attractive opportunities. Even where straightforward shifts of funds through the banking system are not permitted by exchange-control regulations, traders have opportunities

to engage in such movements of funds through the leading and lagging of trade payments.

There are three general approaches to the problem posed by disequilibrating capital movements: to finance them, and avoid sterilizing the monetary effects of the reserve changes; to create a system of capital controls adequate to limit capital mobility; or to modify the exchange-rate system. These will be examined in turn.

The first possibility is to allow the capital flows to take place, and to permit them to produce their automatic monetary effects. This means, for example, that in a country expected to devalue the money supply would be allowed to contract and interest rates would be allowed to rise until such time as the incentive for further capital movements had been eliminated. Experience with the European snake seems to have shown that this policy can be highly effective when the expected change in the exchange rate is small; ^{15/} provided that the policy is credible, hopes of an early devaluation will fade and further movement of funds may come to seem unattractive after a quite moderate rise in interest rates that does not seriously disrupt financial markets or have any major impact on the real economy. Such an outcome is, however, heavily dependent on a market conviction that any par value change that may be made will be small. If there is a belief that a capital gain of, say, ten per cent is potentially available by shifting funds for a few days, then the incentive could be eliminated only if the price of bonds fell by some ten per cent and the interest rate on short-term assets rose to astronomic levels involving annual rates of many thousand per cent. Such changes would be extremely disruptive of financial markets and could be expected to have repercussions on the real economy (both through changes in aggregate demand and enforced bankruptcies). Even if expectations of an imminent ten per cent change could be reduced to, say, the point where the market thought the probability of devaluation over the following two weeks would be no more than 25 per cent, the fall in the bond price necessary to make a risk-neutral investor indifferent between holding his funds at home and shifting them abroad would be a hefty 2.5 per cent, and the short-term interest rate would need to rise by about 80 per cent per annum. The disruption this would entail would scarcely be tolerable. Since market operators would recognize that fact, they would be unlikely to find government assurances that the disruption would be accepted credible - which would mean that it would be difficult to reduce expectations to the 25 per cent assumed in this example once a currency came under pressure. When large changes are in prospect, a run can scarcely be prevented with this policy. In short, it is a policy which can enable a crawling peg, but not an adjustable peg, to function.

The second possibility is to seek to control capital movements through a system of exchange controls. Many types of controls, aimed at limiting both the export and import of capital, have been adopted by countries in the past. The main types of measures to have been used include:

prohibition of certain forms of capital exports or imports;

a requirement that certain forms of capital exports or imports receive individual administrative authorization;

taxes on bonds issued by, or loans made to, foreigners;

prohibition of acceptance of, or payment of interest on, non-resident bank deposits;

the levying of negative interest rates on foreign deposits;

administrative regulations limiting banks' authorized positions in foreign exchange;

limitations on the indebtedness between the local branch of a multinational corporation and foreign branches;

controls of the terms on which commercial payments are made;

dual exchange markets, in which certain types of transactions have to be traded in a different market.

It should be noted that, while dual exchange markets provide scope for individual transactors to vary their supplies and demands in accordance with price, and thus may provide some of the advantages traditionally associated with use of the price system rather than administrative regulations as a guide to resource allocation, they nevertheless create the same need for administrative regulation as the other forms of exchange control. This is because one party always has an incentive to be operating in the other market to that in which they are supposed to transact, and hence it is necessary to have an administrative apparatus capable of examining and classifying each transaction.

Opinions have in the past differed quite sharply as to the relative importance of the costs and benefits of curbing capital mobility through exchange controls. The costs include the absorption of real resources in the administrative procedures needed to supervise and enforce the rules, the danger of choking off legitimate and socially-advantageous transactions, the disgruntlement caused by the need for rulings that are inevitably somewhat arbitrary at the margin, and the incentives created for cheating, bribery, and corruption. The benefits depend on how effective the controls are in limiting disequilibrating capital movements. The C-20's Group on Disequilibrating Capital Movements concluded that a number of countries had 'found controls to be useful in deterring disequilibrating capital flows', but that 'beyond a certain point, none had proved to be fully effective in withstanding massive flows'. ^{16/} Because 'money is fungible', controls have to be comprehensive to be effective. But there are in practice difficult problems in setting up comprehensive controls, particularly in open economies. The best-known gap concerns 'leads and lags' for trade payments: there was a vast speculative outflow from France in 1968-69, primarily through this channel, despite stringent exchange control measures. A recent study of UK trade financing practices concludes that, despite the fairly strict UK exchange controls, the sum that could have been shifted out through leads and lags, had there been a run on sterling at some time during the

first half of 1975, was probably of the order of two-thirds of a month's imports, even without re-writing contracts or violating exchange controls. 17/

The vast size of the speculative flows of the later years of the adjustable peg, and the fact that the pool of mobile capital has continued to grow in the past six years, leave little room to doubt that a significant and general strengthening of capital controls would be a necessary condition for restoration of the adjustable peg. Although past experience with capital controls is not particularly encouraging, there is one way in which it might be possible to make them substantially more effective than they have previously been. This would be to require that all countries adopt comprehensive and consistent capital controls. Prohibited capital movements would then run the risk of detection not once, but twice. There is no experience on which one can base an assessment of whether this might substantially aid enforcement, but it appears a priori plausible to suppose that it would.

Naturally any strengthening of capital controls would be likely to bring certain costs as well as benefits. One such cost of particular importance to many developing countries is that they might undermine the international capital market. For example, an effective offshore bank market requires that the banks operating in it are in a position to arbitrage funds in and out of the issuing country; without this ability, prudence virtually requires them to hold strictly matched positions rather than engaging in maturity transformation, and even clearing is difficult. Furthermore, stricter exchange controls could be expected to curtail the funds that could be deposited in the offshore markets. On both counts, a policy of strengthening capital controls would be liable to reduce the size and efficiency of the Euromarkets.

The third possible solution to the problem of the disequilibrating capital flows that arise under the adjustable peg is to seek another exchange-rate regime which is less susceptible to these difficulties. Mention has already been made of the fact that the crawling peg, although it could still expect to confront speculative pressures, possesses a mechanism for confronting them; namely, to allow the flows to take place and to avoid sterilizing the monetary consequences, so that crawl-adjusted interest rates are arbitrated into equality (after allowing for risk). The other response is that which was in fact adopted by the industrialized countries; namely, to abandon the par value system and adopt floating exchange rates.

Speculation plays a fundamentally different role under floating rates. The current account (or the basic balance) cannot adjust in the short run so as to clear the market - indeed, short-run adjustments are likely to be perverse and contribute to instability. 18/ Since the central bank withdraws from any systematic assumption of the responsibility for ensuring that the foreign exchange market clears, operation of a floating system requires that speculators take on that

task by buying a currency that is in excess supply and selling one that is in excess demand. How satisfactorily a floating rate will operate depends heavily on whether there is an ample supply of perfectly-competitive speculators who have a reasonably clear idea of the equilibrium rate and are willing to supply funds to, or withdraw funds from, the market, in response to modest deviations of the actual rate from their notion of its equilibrium. This is a behaviour pattern which, as Milton Friedman long ago argued 19/, would be both profitable to the speculators (unlike destabilizing speculation, under classical assumptions) and socially advantageous. Experience with floating rates in the 1970s has not, however, been entirely reassuring as regards the stabilizing qualities of speculative behaviour. Mention was made in the previous section of some occasions when speculative movements clearly carried important exchange rates to levels more depreciated than any reasonable assessment suggested to be justified, and there have been equally clear examples of currencies carried to unrealistically high levels (notably the yen and the Swiss franc in 1978). Such exchange crises have not been ended by a depreciation or appreciation smoothly inducing an inflow or outflow of stabilizing speculation, as many economists had argued would occur under floating rates. Empirical work has found some evidence of destabilizing 'bandwagon' effects. 20/ (Of course, this is not to say that crises might not have been even more severe under the adjustable peg.)

(c) Inflation

A fixed exchange-rate system requires that inflation rates be essentially 21/ similar between countries, whereas exchange-rate flexibility in any form allows for them to diverge. However, this does not in itself imply anything about whether one regime is more inflationary than another, which is a topic on which consensus has not yet been achieved. A traditional view was that a more flexible regime would be more inflationary, because it released governments from the balance-of-payments discipline to keep their inflation in line with the international norm. However, it has been counter-argued (1) that, in a world as inflationary as the present one, the need to remain in line with the international norm may exert an inflationary rather than an anti-inflationary pressure, and (2) that a depreciating currency, with its rapid pressures on the price level, may be a more potent discipline than a reserve loss, the unpleasant consequences of which tend to be veiled from the general public for a considerable time. Both sides in this argument have drawn on the events of the 1970s to support their positions, one by pointing to the widespread acceleration of inflation in the year following the move to floating rates, the other by pointing to countries like Germany where the acceleration of inflation was reversed after the move to floating or countries like the UK where depreciation prompted acceptance of an IMF standby programme. There does not as yet, however, seem to be any systematic as opposed to casual evidence: it would therefore be risky to base a choice between regimes on these considerations.

A second reason for expecting a flexible exchange-rate regime to be more inflationary is based on the existence of 'ratchet effects'.

When a currency depreciates, import prices are pushed up and export prices are pulled up; these changes lead to a general rise in the price level as a result of the cost-push pressures on industries using imported inputs, the easing of foreign competition in the import-competing industries, and the greater incentive to seek - and ability to pay - higher wages. The contrary forces tend to operate when a currency appreciates; however, when prices are sticky downwards, these tendencies may be frustrated and not result in a fall in the price level. Hence, if a currency first depreciates and then appreciates, the price level will end up being higher as a result of the 'ratchet'. Since that higher price level would imply higher unemployment on the basis of unchanged fiscal-monetary policies, there would be pressure on the authorities to adopt more expansionary policies, which would ratify the inflation.

This theory provides a rather convincing account of how exchange-rate fluctuations could generate a higher over-all world rate of inflation, and it has indeed been argued (especially in Italy) that such 'vicious circles' have operated since the move to floating. Nevertheless, two reservations must be made. The first is that empirical confirmation of the ratchet effect is still largely lacking, despite studies attempting to detect it. ^{22/} The second is that, when there is a positive rate of inflation even in the country with the appreciating currency, the disinflationary effects of the appreciation may be able to operate even if prices are rigid downwards. But note that these two reservations may neutralize each other: perhaps the empirical studies of the early years of floating could not detect a ratchet effect precisely because inflation was so widespread that it was present even in the countries with the appreciating currencies. In a situation where some countries are close to price stability, an appreciation of their currencies might indeed have a net inflationary impact on the world economy.

There is therefore some basis for regarding exchange-rate fluctuations as undesirable because of their possible inflationary impact. The word 'fluctuations', to indicate change in both directions, is used advisedly here; trend changes that are needed to neutralize differential inflation rates or to secure payments adjustment cannot be foregone because of the uncomfortable fact that they may accentuate inflationary pressures. The critical question in choosing between exchange-rate regimes is, therefore, which of them promise to avoid (reversible) exchange-rate fluctuations. It seems fairly certain that no system of floating rates can provide such assurance, since the condition for a floating rate to be what it is is (almost) that it be regarded as equally likely to move in either direction next period. In contrast, the experience of the adjustable peg did not give grounds for regarding that system as prone to generate fluctuations that were subsequently reversed. One cannot be quite as certain that the crawling peg would be equally satisfactory in this respect; certain formulae or practices for changing the peg, such as equating it to a moving average of past market rates or changing the peg whenever reserves deviate from a target zone, would seem prone to introduce a cyclical element into the exchange rate (though probably a rather minor element in comparison with the fluctuations that have

occurred under floating). However, there seems little reason to suppose that practices of the type that have actually been employed up to now, where changes in the peg are related to actual or projected price trends perhaps modified by the apparent need for payments adjustment, possess this undesirable property.

There are several connections between the exchange-rate regime and inflation that are probably more important than the issue of the susceptibility of the crawling peg to fluctuations when it comes to choosing between the crawling peg and the adjustable peg. The first is the problem of monetary control. It is well established that use of the adjustable peg in inflationary countries creates grave difficulties of monetary control, since there are strong pressures to create credit in the run-up to devaluation to prevent the capital outflow unduly deflating the real economy, and it is difficult to sterilize the repatriation of capital that follows the devaluation. ^{23/} There seems to be considerable agreement that the crawling peg can, and indeed has when it has been used, overcome these difficulties rather well. (This is really another aspect of the differing abilities of the two systems to accept and implement a non-sterilization rule, which was discussed in the previous section.) Second, it has been argued that a substantial devaluation may provide a sufficiently dramatic occasion to seek a social consensus on pruning back inconsistent real income claims to more realistic levels with some prospect of success, while adoption of a crawling peg eliminates such opportunities. ^{24/} Third, it is widely agreed that a crawling peg provides more scope for coalescing price expectations than does an adjustable peg, but there is not as yet a consensus as to whether or not this is a good thing. Some have argued that coalescing price expectations around a declining inflationary trend can provide an important support for an anti-inflationary programme, while others have argued that the effect would be to imbed inflationary expectations more deeply and so ensure that a devaluation achieved through the crawling peg would have minimal real effects and merely serve to accelerate inflation. It is possible that some of these arguments will ultimately prove important in choosing between the two regimes, but it cannot be claimed that sufficient professional consensus has yet been established to provide an unambiguous basis for rational choice.

(d) Macroeconomic Management

It was traditionally argued that one of the great advantages of adopting a floating exchange rate would be that this would liberate monetary policy for the unfettered pursuit of internal stabilization objectives. There was general agreement that monetary policy would be a more potent instrument for influencing real income with a floating exchange rate, especially under conditions of high capital mobility. There was indeed a contrary argument which held that with a fixed exchange rate the balance of payments could act as a built-in stabilizer and disperse the effects of national 'shocks' - but even this argument was downgraded in the early 1970s when it was realized that high capital mobility could enable the external sector to play this shock absorber role without any need for a fixed exchange rate and

movements of official reserves. Hence the dominant view at the time of the adoption of floating was that economic policy should be better able to promote full employment and price stability without the need to be distracted by external concerns.

In fact, of course, the mid-1970s were characterized by world-wide stagflation, in which all the major countries operated substantially further from full employment for a far longer period than at any other time since the end of the Second World War, rather than by a closer approximation to non-inflationary full employment. There are without doubt many possible explanations for this unsatisfactory performance that have nothing to do with the adoption of floating rates: the high level of inflation inherited from the Vietnam War and the 1973 boom, the oil price increase, and the exhaustion of the options for easy growth in many of the OECD countries as a result of the approach to economic maturity. Nevertheless, it is proper to probe recent history with a view to considering whether the international monetary system could also have contributed to the unsatisfactory performance of the world economy in the 1970s.

In another recent paper, 25/ I sought to examine whether and in what ways the recent disappointing performance of the world economy might be a consequence of the changes in the international monetary system. I argued that there are indeed certain ways in which the two are linked: through periods of exchange-rate overvaluation doing permanent damage to productive capacity by causing bankruptcies in the tradable goods sector, and thus cutting potential growth rates; through the ratchet effects outlined in the previous sub-section; and through weaknesses in the co-ordination of economic policy. The latter were manifested in the lengthy arguments between the OECD countries about the so-called 'locomotive' and 'convoy' approaches to economic recovery following the 1975 recession. One particularly unfortunate incident occurred in the second half of 1976, just as the weakness of the recovery from world recession was first becoming evident. At that time four of the major European economies (France, Italy, Sweden, UK) were subjected to quite severe deflationary measures. They acted in this way because they feared that they were caught up in a 'vicious circle' of depreciation and inflation that it was necessary to break. Whether they were right in this belief or not, there can be little doubt but that the net deflation thus imposed on the world economy was inappropriate. There is no obvious example of comparably inopportune conjunctural policies having occurred during the period of the Bretton Woods system.

There are therefore some reasons for believing that international monetary disorder may have contributed to the macroeconomic problems of the 1970s. In my final evaluation, however, I conclude that these factors are minor compared to the two reasons why inflation has come to accelerate at much lower pressures of demand than it used to in earlier years: (1) the apparent rise in the 'natural rate of unemployment' in the industrial countries, and (2) the pressures on the oil price that arise when the demand for oil comes close to capacity constraints.

(e) Payments Adjustment

One of the principal arguments for exchange-rate flexibility has long been that an exchange-rate change provides a non-distortionary way of altering the composition of expenditure between domestically-produced and foreign-produced goods so as to permit payments adjustment without the creation of domestic inflation or prolonged unemployment. The argument has, however, been subjected to three criticisms since it was first elaborated by Meade in the early 1950s.

(1) The 'absorption approach' argued that a devaluation can easily fail to remedy a deficit because it does not release the domestic resources that must go into the balance of payments to make any improvement (on current account) possible. It has long been generally agreed that this is true, and that the implication is that a devaluation needs to be accompanied by a deflationary policy if the economy does not already have a margin of slack. Although it is also sometimes true that deflation alone will be adequate to secure payments adjustment, this in no way undermines the case for changing the exchange rate when competitiveness is inappropriate, which can prevent the necessary demand deflation leading to a secondary and unnecessary loss in output and employment.

(2) The 'elasticity pessimists' argued that the foreign trade elasticities are so low that a devaluation might worsen rather than improve the balance of payments. There has now been extensive econometric research on this topic, and the consensus is that the elasticities are indeed typically low in the short run, but that they are quite high enough to ensure that relative price changes can produce expenditure switching to adjust the balance of payments over a time span of two or three years. The implication is that adjustments in the real exchange rate can provide a most useful instrument of economic policy over the medium term but that to attempt to use them for making quick adjustments can only give rise to expectations that are disappointed.

(3) Most recently, the 'world monetarists' have argued that prices of tradable goods are equalized internationally through arbitrage, and that real wages are rigid, so that an exchange-rate change cannot realign relative international prices and costs in order to generate expenditure switching. In so far as a devaluation causes a current account adjustment, it does so by inflating prices and thus decreasing the real value of the money supply and hence by cutting expenditure; i.e., by expenditure changing rather than by expenditure switching - which can equally well be accomplished directly by monetary policy. Empirical investigation of this topic is now proceeding apace. ^{26/} It already seems to be well established (i) that a substantial part of an exchange-rate change is indeed characteristically offset by domestic price adjustments, but (ii) that this offsetting is not complete in the short run (for trade in industrial products). What remains to be resolved is whether offsetting is normally complete in the medium run.

A plausible answer that seems to be consistent with the mixed results so far available is that it all depends: that an exchange-rate change does not mechanistically guarantee that a change in relative prices can be made to stick, but that it sometimes provides a useful instrument to engineer a necessary correction of relative prices at a lower cost in terms of resource dislocation than would otherwise be necessary;

The experience of flexible rates during the 1970s has provided a new opportunity to assess their effectiveness in promoting adjustment. There have in fact been very large swings in payments positions (on current account) in the 1970s. For example, the United States went from a deficit that peaked in 1972 to a large surplus that peaked in 1975 and back into large deficit in 1977-78, with a notable improvement since. Japan has also had large fluctuations that were almost a mirror image of those in the United States, except that the Japanese deficit peaked in 1974 rather than 1975. Among European countries, Italy and the UK started out the 1970s with the largest surpluses in Europe, both then went into chronic deficit, before recovering. Sweden developed a large deficit which peaked in 1977 and then recovered. All of these developments are consistent with changes in real exchange rates and demand pressures, once it is recognized that changes in competitiveness should not be expected to produce their effects rapidly, and may indeed produce perverse effects in the short run. Even the German current balance has finally adjusted to the real appreciation of the DM. These experiences provide further evidence in support of the position that exchange-rate changes provide an effective instrument to promote adjustment in the medium term.

All of the exchange-rate regimes under review provide the possibility of using exchange-rate changes in order to promote adjustment. Paradoxically, it can indeed be argued that a par value system may be more effective than a floating system to this end, since an appreciation or depreciation of a floating rate does not provide the same assurance as a deliberate revaluation or devaluation that the change will be maintained, and therefore that a change can be taken as a reliable guide for the purpose of determining resource allocation. However, where par value changes are treated as a policy of last resort, as happened under the adjustable peg in the 1960s, this potential advantage of a par value system is somewhat hypothetical. One of the reasons that the crawling peg was proposed is precisely that of permitting the reinstatement of exchange-rate changes as an active instrument of adjustment. Just how well the crawling peg could be expected to perform in this respect would depend upon the practices used to determine exchange-rate changes; if the nominal crawl were subject to a fixed maximum (as in the original academic proposals), the exchange rate would be unable to contribute to adjustment between two countries whose rates of inflation differed by more than the permitted maximum rate of crawl. However, no such problem would arise where the crawl was set equal to the inflation differential plus an adjustment allowance. 27/

3. Appraisal

The preceding review has not revealed a compelling case for seeking to preserve the existing important role for floating exchange rates. Floating has without doubt increased exchange-rate instability, which has probably had significant adverse effects; it has not ended speculative exchange crises; it may have contributed to global inflation through ratchet effects, though this is unproven; it has not brought the expected improvement in the potency of stabilization policy; and it is not even clear that it has provided the best environment for exchange-rate changes to play their role in the adjustment process. Such advantages as floating has brought, notably in easing the problem of speculative runs that plagued the final years of the adjustable peg, are advantages primarily to the industrialized countries. Given that they cannot themselves float because of the smallness and underdevelopment of their financial markets, developing countries have little reason for appraising a floating regime positively except in so far as it may be a necessary condition for developed countries to avoid deflationary or restrictive policies. The only obvious reason for arguing that it may have played such a role is that speculative pressures on deficit countries might have been even more severe under the adjustable peg.

One cannot, however, ignore the fact that the adjustable peg was not abandoned by the industrialized countries as an act of reasoned choice, but because of *force majeure*. The forces responsible were the acceleration of world inflation and the consequential divergences in national inflation rates, coupled with the increasing speculative pressures surrounding the exchange-rate changes needed to offset the inflation differentials. These forces have not been overcome: the average inflation rate remains high and inflation differentials remain large, and the stock of mobile capital has continued to expand. Any return to pegged exchange rates would have to be designed to accommodate those realities.

The analysis of Section 2(b) above identified two alternative forms that such accommodation might take. One would involve a reduction in international capital mobility through tighter exchange controls. The disadvantages of this approach include the well-known costs of employing exchange controls, the limited effectiveness that past experience suggests can be expected of such controls, and the danger that, if effective, the controls would curtail the international capital market. The first two of these disadvantages are primarily of concern to the developed countries; they are nevertheless relevant to an assessment of where the interests of developing countries lie inasmuch as they may cast doubt on whether the developed countries could be persuaded to accept this solution. The final disadvantage would represent a severe cost to those developing countries that have emerged as significant borrowers in international capital markets in the past decade.

The alternative form of accommodation would involve following the

path originally pioneered by some of the developing countries in Latin America and recently adopted de facto within the European Community, by adopting a crawling peg rather than an adjustable peg. An advantage of this solution is that (provided central banks avoided sterilization) speculative capital flows could produce a loosening or tightening of monetary conditions that would automatically limit flows to financeable levels. How well a crawling peg would perform would naturally depend, inter alia, on the practices used to determine changes in the peg. While this subject is too detailed to justify discussion here, it may be mentioned that the author's own preference would be for a rule by which the nominal exchange rate is normally adjusted in line with the inflation differential between a country and its trading partners so as to maintain its effective real rate constant, but with provision for making gradual changes in that real rate, subject to IMF approval, in pursuit of payments adjustment. 28/

V. Co-ordination of Economic Policy

It is a truism that satisfactory performance of the world economy is dependent upon consistency between the economic policies adopted in the individual countries into which the world is divided. For example, avoidance of depression and demand inflation requires that the sum of aggregate demands add up to the productive potential of the world economy (while, in a world of capital mobility, there is no similar requirement that absorption be equal to full capacity output in each individual country). Similarly, inconsistency in balance-of-payments objectives, either in the sense that reserve accumulation ambitions do not sum to the increase in the global supply of reserves or in the sense that the sum of targeted current deficits and surpluses be different to zero, might provoke competitive payments policies such as escalating trade restrictions, competitive devaluation or deflation, or an interest-rate war. The question considered in this section is whether the need for consistency in economic policy creates a need for some mechanism to coordinate policies, and what forms such coordination might take.

It is worth noting that, at least in principle, the classical gold standard provided a mechanism for achieving the necessary consistency in economic policies automatically. The strict gold standard involved each country maintaining a fixed exchange rate between its money and the unique reserve asset, gold; an exogenous supply of gold; and in each country a fixed ratio between the country's gold holdings and its money supply. Provided that prices were sufficiently flexible to maintain economies close to full capacity operation, this ensured a broad measure of consistency in both demand and payments 'objectives' (which were implicit rather than explicit). If world demand were above (below) full capacity, the change in the price level would change the real value of the fixed world nominal money supply so as to contract (expand) demand and restore equilibrium. A country with a gold loss (i.e., an overall balance-of-payments deficit) would be under contractionary pressure, which would be matched by a corresponding expansionary pressure in the surplus country. Monetary flows therefore induced a tendency for expansions in some countries to offset

contractions in others, thus limiting world cyclical swings. It is true that some doubt has been cast on the extent to which the gold standard did historically act like its theoretical prototype, ^{29/} in part because price flexibility was not sufficient to prevent severe recessions, but the rules of the system were surely a factor in the observed absence of policy conflicts in the period prior to the First World War.

1. Options

Up to the present time, such coordination of economic policy as has occurred has continued to be accomplished through the reserve stock: a country's adjustment obligations are both defined and policed by the need to avoid reserve depletion, just as under the gold standard. The most well-known proposals for reforming adjustment obligations have all been based on maintenance of this central role for reserves, and indeed on enhancing it by making it apply to situations where countries have been able to evade the discipline of reserves. For example, the war-time Keynes Plan for an International Clearing Union proposed to create an obligation to avoid excessive cumulative surpluses (to match the obligation to avoid excessive cumulative deficits inherent in the reserve constraint), and to police this obligation by charging interest on excessive deposits of *bancor*. More recently, the United States advanced a very similar idea, in the guise of the reserve indicator proposal, in the course of the C-20 negotiations. On the same occasion, the European countries proposed the introduction of asset settlement, which was intended to discipline the country that was able to evade the reserve constraint by virtue of its ability to issue the principal reserve currency. Despite the antagonism that was generated between the advocates of these two proposals, it is noteworthy that both of them involve continuing to base adjustment obligations on the stock of reserves: the differences centred merely on which asymmetries in the application of this criterion were to be eradicated. It is natural to take the set of ideas adumbrated (though never endorsed) in the C-20 as the first of the options for consideration.

- (C-1) Reserve Indicators. Each country would be assigned a target trend for its net ^{30/} reserves; these target trends would sum to the actual net stock of reserves. Deviation of reserves from the target trend beyond determined indicator points would be penalized by interest charges, which might become progressively larger with both the extent and the duration of the deviation from target.

During the 1960s there were discussions in OECD's Economic Policy Committee and Working Party No.3 directed at achieving agreement on consistent current-account aims for the principal OECD members, and attempts were periodically made to introduce an element of moral pressure on surplus countries. Following the oil price rise of 1973, there were a number of proposals to seek wider and explicit agreement

on current account targets, with the intention of minimizing the danger of competitive payments policies resulting from the unavoidable need for a collective current account deficit of the oil importers much in excess of their previous aggregate current account outcomes. Hence a second possible basis for the international coordination of economic policy would involve the specification of targets for the current account, presumably with appropriate incentives to encourage compliance. The current balance targets for developing countries should, of course, be such as to reflect the resource transfer that they can use productively in development. These targets might be specified anew each year, with bygones (i.e. past imbalances) treated as irrelevant; they might take the form of a cumulative current balance indicator, in which indicators were placed on the deviation of the cumulative current balance from its cumulative target; or, as a compromise, the target might be adjusted to require a country to aim to reverse in the following year some fraction of the deviation of its past cumulative current balance from its past cumulative target. To avoid cluttering the analysis with an excessive number of slightly-differing variants, the last case is taken for concreteness. It is again assumed that, if there were going to be penalties for deviations from payments targets, these should take the form of moderate, semi-automatic charges as initially proposed by Keynes. (This type of proposal generated markedly less hostility in the C-20 than any other.) The second option may be formalized as follows. 31/

- (C-2) Current Balance Targets. Each country would be assigned a target current account balance which would reflect (a) a resource transfer based on its 'underlying' capital flow; (b) partial reversal of the past deviation of its cumulative current balance from its cumulative target; and perhaps (c) an allowance for the effect of factors beyond its own control. 32/ Elements (a) and (b) would sum to zero for the world as a whole. A deviation of the current balance from its target beyond determined indicator points would be penalized by financial charges, which might be progressively higher the greater the deviation.

It has for some time been commonplace to refer to the need to coordinate monetary policy, but it is only in recent years that any very precise ideas as to what is involved in such coordination, if it is to be effective, have begun to appear in the literature. 33/ These ideas were first developed in the context of determining the monetary policies that would be required to support a system of fixed exchange rates, but they can easily be extended. The essential principle is that what should be coordinated are rates of domestic credit expansion, as opposed to either rates of growth of the money supply or interest rates. It is an integral part of the proposal that reserve flows should be allowed to influence money supplies rather than domestic credit expansion, i.e. that sterilization should be avoided.

In the first versions, where the objective was to support a locking of nominal exchange rates, the criteria that it was suggested

should determine rates of domestic credit expansion have been (a) a country's trend rate of real growth and its estimated income elasticity of demand for money, and (b) the common target rate of inflation of the exchange-rate union. (Where inflation is regarded as unacceptably high, this target is frequently envisaged as a fraction of the inherited rate of inflation.) It is not difficult to see how these principles could be extended to cope with a world where exchange rates may change and where there may be a desire to implement an anticyclical policy. Differential rates of inflation (which in general require exchange-rate changes) could be accommodated by providing that each country should substitute its own target rate of inflation under (b); a common gradualist anti-inflationary strategy could be implemented by making these targets the same fraction of individual countries' inherited rates of inflation. An element of anticyclical policy could be introduced by adding (subtracting) a sum equal to some specified fraction of the estimated deflationary (inflationary) gap, where the latter might be set individually for each country or collectively for the world. The second procedure would be regarded as more appropriate by those who believe that interdependence is now too great to make national anticyclical policies viable. Another possible modification to the formula would involve augmenting (reducing) domestic credit expansion by a specified fraction of the excess (shortfall) of the current balance above (below) its target, so as to provide a reinforcement for the adjustment process. These ideas can be summarized as follows.

- (C-3) Domestic Credit Expansion Targets. Each country would be assigned a target rate of domestic credit expansion which would reflect (a) its trend rate of real growth and its estimated income elasticity of demand for money; (b) a specified fraction of an appropriate past rate of inflation; perhaps (c) a specified proportion of its deflationary gap, or of the world deflationary gap, and/or (d) a specified fraction of the excess of its current balance over target. Reserve changes should not influence the pursuit of this DCE target. A deviation of DCE from its target beyond defined indicator points might be penalized by financial charges of progressive intensity.

No doubt many conceivable further options could be developed. For example, one could draw on the example of recent summit meetings and examine the possibilities of coordinated targets for output, growth or absorption. However, any systematic creation of international obligations to accept and respect such targets seems even more fanciful than the options already discussed, for several reasons: the even sharper intrusion in affairs currently regarded as within the sovereign prerogatives of individual nations; the even greater possibilities of slippage between intentions and results, which would make penalties excessively arbitrary; and the even larger scope for reasonable disagreements about objectives. Consequently the options will be limited to the three outlined above, plus the existing laissez-faire arrangements, which can be characterized as follows.

- (C-4) Laissez-faire with a residual reserve constraint. Each country is obliged to avoid reserve depletion. However, there is no analogous limit to reserve accumulation, no obligation on reserve centres to avoid liability financing large opportunities for many countries that are not reserve centres to borrow on the international capital market and thus avoid the traditional need to tie current account adjustment to a reduction in reserves, and no requirement to tie domestic monetary policy to the reserve stock.

The final option that will be considered is a mutation on present arrangements that has recently been proposed in a UNDP/UNCTAD Report. 34/ The principle urged is that the origin of a payments disturbance should be taken into account systematically in determining the need for adjustment. Specifically, countries should not be expected to undertake rapid adjustment in response to circumstances outside their own control. This principle is already embodied in the IMF's Compensatory Financing Facility, which implements it by providing additional balance-of-payments finance with a low degree of conditionality where it is established on reasonably objective criteria that a deficit is due to an export shortfall due to circumstances beyond the country's control. The principle could be extended by making low-conditionality Fund credit available to a country suffering a payments deficit for any reasons beyond its control, presumably in an amount up to some fraction of the estimated payments impact of unfavourable temporary factors and up to a tapering fraction of unfavourable permanent factors. If a system of current balance targets were in operation as provided in option (C-2), it would be logical to complement the provision of finance by the IMF with an appropriate modification of the current account target as provided in part (c) of that option.

- (C-4A) The UNDP/UNCTAD Principle. Members of the IMF would be eligible for low-conditionality finance for a part of payments deficits established as being due to circumstances beyond their own control. The proportion of the estimated adverse impact effect for which this finance would be available would taper off gradually where the adverse change was believed to be a permanent one.

2. Criteria for Evaluation

(a) Policy Consistency

The logic that has generally been invoked to support proposals for tighter specification of adjustment obligations is that of avoiding inconsistency in the policy objectives of different countries. Various unfortunate consequences have in the past been ascribed by some observers to the absence of such consistency: competitive devaluation

(1930s), general deflation (1930s and perhaps 1970s), escalating trade restrictions (1930s and 1970s), and interest-rate wars (1967). During the 1960s, the idea that such competitive payments policies were likely to occur if the world reserve supply were not expanding at an adequate rate played a central role in motivating the negotiations that ultimately led to introduction of the SDR. In 1974 there was a similar concern that the inescapable need for a large collective current-account deficit by the oil importers would lead to competitive payments policies, which was reflected in the Rome Communiqué of the C-20 (though not in agreed targets). Some have pointed to the absence of subsequent competitive depreciations to argue that these fears were misplaced; others have argued that both the erosion of liberal trading policies and the failure of some surplus countries to reflate away their surpluses promptly owe much to the absence of agreed formal obligations.

The two proposals addressed directly to securing consistency in payments objectives are the reserve indicator proposal and current balance targets. Obviously the central issue in choosing between these two is that of whether inconsistency stems mainly from inconsistent reserve accumulation targets or inconsistent current account objectives. Although the former possibility has received much attention in the past, and indeed won official endorsement in the course of the SDR negotiations, it seems very doubtful whether the possibility of an inappropriate reserve supply leading to competitive payments policies deserves much credence under present conditions. In part this is because the very creation of the SDR has already provided the international community with a policy instrument able to eliminate inconsistency resulting from a reserve shortage, and in part because the elasticity of reserve supply under the reserve-currency system and its Euromarket extension means that the system could generate more reserves to meet increased demand even if the SDR did not exist. Inflationary pressure stemming from a surfeit of reserves also seems markedly less likely now than in the early 1970s, primarily as a result of the adoption of flexible exchange rates by the industrial countries, which imply that an expansion of currency reserves no longer carries with it an implication that domestic money supplies will expand. ^{35/} The main qualification to this argument arises from the possibility of speculative rises in the gold price inducing many countries to simultaneously adopt the more expansionary policies that they feel able to afford with the enhanced value of their gold reserves. As already argued in Section II.2(b), however, the stock of reserves no longer plays a strategic role in present international monetary arrangements; and so long as that remains true, inconsistent reserve objectives can hardly generate serious problems.

It would therefore seem that, if the question of adjustment obligations is a source of concern, this must be because of inconsistency in current account targets. At one time it would have been possible to argue that such an inconsistency might nevertheless be resolved by creating more reserves, since this would have encouraged the typical country to accept a larger current deficit. However, the growth in capital mobility implies that this effect might now be quite weak: under current conditions it could be expected that the major

effect of an SDR allocation would be on capital flows rather than on current imbalances. Similarly, achieving consistency in reserve-accumulation objectives through a reserve-indicator mechanism would imply little about consistency of current balance targets with high capital mobility. There can therefore be no evading the issue of whether the current deficits that can be sustainably financed and will be willingly accepted by the deficit countries can be relied upon to sum to the current surpluses desired by (or structurally imposed upon) the surplus countries, at a satisfactory level of world demand.

Opinion is divided on this issue. A neo-classical approach would suggest that the danger of inconsistency need not be a source of concern; for example, an advocate of this view would argue that a surplus country will inevitably place the funds generated by its surplus on the world capital market, where they would bid down the world rate of interest and so stimulate more spending elsewhere, which would in turn be financed by the funds borrowed from the world capital market by the deficit country and supplied by the real resources whose international transfer constitutes the current imbalance. ^{36/} There are, however, several counter-arguments which may be developed to question whether the price mechanism always operates as effectively as pictured in the neo-classical analysis. ^{37/}

(1) It may be agreed that the above reasoning is in general convincing, but nevertheless be maintained that there are particular situations (such as during the slump of the 1930s, or following the oil price increases of 1973 and 1979) when inconsistency can be very real.

(2) It can be argued that, because of its neglect of growth considerations, the neo-classical analysis overlooks a possible source of conflict of interest between countries. According to this line of thought, a strong current balance may increase the propensity to invest (e.g. by improving confidence), and within limits this effect may outweigh the benefit of the increased availability of real resources to undertake investment that is furnished by a larger current deficit. An element of mercantilism may for this reason be rational for countries interested in high rates of growth.

(3) It may be that, because borrowing is limited by a creditworthiness constraint, deficit countries would confront difficulties in continuing to borrow the funds needed to finance deficits large enough to absorb the full-employment surpluses of the structural surplus countries, even if they wished to do so.

(4) The neo-classical analysis might be queried on the Keynesian argument that the effect of savings exceeding investment (ex ante) is to depress the level of income rather than to reduce the rate of interest.

(5) It might be agreed that the adjustment process postulated by

neo-classical reasoning operates in the long run despite the validity of the preceding Keynesian argument in the short run, but nevertheless be argued that the long-run adjustment mechanism is so slow that world conjunctural fluctuations could be substantially reduced by constraining the ability of countries to run abnormally large surpluses during world recessions and abnormally large current deficits during world booms.

(b) Conjunctural Stabilization

The last of the above counter-arguments raises a second general area that has sometimes been used to motivate proposals for the international coordination of economic policy - namely, the possibilities of contributing to stabilization of the world conjuncture. As already pointed out, the gold standard did possess a built-in monetary stabilizer, inasmuch as reserve gains by (and therefore monetary expansion in) one country were matched by reserve losses (and therefore monetary contraction) by another. Something of this mechanism probably survived in the Bretton Woods system for as long as exchange rates remained viscous and the reserve stock largely exogenous, i.e. until about the end of the 1960s. It may not be a coincidence that the breakdown of Bretton Woods was marked by an unprecedentedly high degree of synchronization of the world cycle, which is generally agreed to have contributed powerfully both to the inflationary impact of the 1973 boom and to the intractability of the subsequent recession.

A reserve indicator system would reinstate the built-in stabilizer property of a system with a fixed stock of reserves. However, the same reasons that suggest that a reserve indicator system might do little to remedy inconsistent payments objectives under present conditions tend also to suggest that the stabilizing properties of such a system might now be rather limited. In particular, reserve inflows (outflows) no longer exert much pressure to expand (contract) the money supply.

There seems little reason to suppose that a set of current balance targets need in themselves exert much anticyclical influence, since countries could equally well satisfy any particular set of objectives either with a high or a low pressure of demand, so long as it was evenly distributed. At most, it might constrain a limited number of countries from acting as a drag on general recovery, in the manner that it has been asserted Japan did in 1976-8. However, in conjunction with the UNDP/UNCTAD proposal as embodied in part (c) of (C-2), a set of current balance targets might be expected to operate in a highly stabilizing way. This would occur provided that a change in exports caused by other countries' deviations from 'full employment' ^{38/} were classified as a temporary factor beyond the country's own control, while a change in imports (or for that matter exports) caused by a country's own deviation from 'full employment' be classified as the country's own responsibility. With this (natural) interpretation, a world boom would result in the typical country having its target surplus increased or its target deficit reduced, since the increase in

its exports caused by the boom elsewhere would pull its target up without the increase in its imports caused by its own boom having an equivalent effect in pulling its target down. Since the typical country would not experience an improvement in its actual current balance to match the increase in its target, it would have an incentive to adopt (stabilizing) deflationary actions. Similarly, during a world recession the average country would have its target surplus reduced or its target deficit increased, and the world sum of current balance targets would become negative, with stabilizing incentive effects.

Agreed DCE targets might also be endowed with stabilizing conjunctural properties. Part (c) of (C-3) provides precisely with this end in view that each country should vary its rate of domestic credit expansion in accordance with the deviation of output from its 'full employment' level, either in the country itself or in the world as a whole. It would be a nice question for research as to which of these two rules could be expected to be the more stabilizing in a world as highly interdependent as ours now is.

Of course, there is a school of thought associated with Milton Friedman which holds that 'fine tuning' is best not attempted at all because forecasting ability is so poor that actions taken with the aim of stabilizing the conjuncture are as likely to do the opposite. This view perhaps looked more convincing when Keynesian fine-tuning policies were being largely successful in ironing out cyclical fluctuations (up to about 1970) than it does today, a decade after the systematic pursuit of Keynesian policies was abandoned and the apparent result has been increased instability. However, if this judgment represents the collective international wisdom, it could easily be incorporated by providing that current balance and DCE targets be set independently of the conjunctural situation.

It is also possible that a system of DCE targets might have a role to play in a concerted global anti-inflationary strategy. If ratchet effects indeed have the inflationary impact under floating rates that some have claimed (see III.2(c) above), then a return to pegged rates might be an important aid to the reduction of inflation. However, a return to pegged rates without commitments to DCE targets might undermine monetary restraint (which is universally agreed to be a necessary condition for a low rate of inflation) in the presently low-inflation countries; and even before this occurred, the belief that it would be likely to occur might have unfortunate effects on inflationary expectations. A common commitment to a gradualist anti-inflationary strategy with a decelerating rate of domestic credit expansion in all countries could provide necessary reassurance both that world monetary growth would be impervious to individual national payments outcomes and that monetary shortages in individual countries could be relieved by importing money through the balance of payments rather than by forcing a choice between a serious recession and renewed monetary growth.

The UNDP/UNCTAD proposal in isolation (i.e., without a set of

current balance targets) might be expected to provide a stabilizing expansionary effect during a world recession. This expansionary effect would be diminished, but not reversed, during a world boom, which presumably might provoke criticism that the proposal suffers from an inflationary bias. If the previously expressed doubts as to the significance of reserves under present conditions are accepted, one would expect both the stabilizing effect during recessions and the inflationary bias to be rather modest.

(c) Transfer of Real Resources

One of the principles of particular interest to developing countries established in the C-20 negotiations is that an important criterion for judging international monetary arrangements is whether they facilitate the transfer of real resources to developing countries. One of the proposals under consideration, namely, that for Current Balance Targets, is highly relevant in that context.

Medium-term current balance targets should presumably reflect both (a) the resource transfers that would be desirable on grounds of allocative efficiency, and (b) the imbalances that countries can expect to finance on a sustainable basis by capital flows. Since rates of return are typically high in countries where development is in full progress, while savings are limited except where the country has an extraordinary source of external revenue (such as major oil receipts) and thus a current account surplus, the first criterion would certainly point to the desirability of large resource transfers (i.e., current account deficits) for the more dynamic non-oil developing countries. It would obviously be inappropriate, however, to assign these countries large target deficits that they would not be in a position to finance. But the very fact that the international community endorsed such targets might reassure lenders and thus enhance the sums that such countries can prudently borrow. Well-constructed current balance targets might therefore have a helpful role to play in facilitating resource transfers directed to development, particularly in the more dynamic non-oil developing countries.

Naturally this desirable outcome is dependent on the current balance targets being appropriately selected. Obviously economists do not, and never will, know enough to calculate in any exact way the economically-optimal levels of resource transfer or the levels of sustainable capital flows that should jointly determine the 'underlying capital flows'. It has sometimes been concluded from this that it is wrong in principle to attempt to reach agreement on current account targets: even if reasonable estimates could be made for the past (of which there is no assurance), an agreement on current account targets might prevent prompt adjustment of resource transfers to changes in the pattern of capital flows and thus freeze resource allocation in a pattern that could become increasingly distorted over time. Others may feel that such distortions are likely to be modest, at least in comparison with the losses sometimes imposed by countries tacitly accepting quite inappropriate current balances simply because a rational

objective has never been formalized, or the possibility that a sudden withdrawal of confidence by the international capital market may dictate severe retrenchment.

(d) Adjustment Costs

The specification of adjustment obligations may influence the costs incurred in securing payments adjustments. It is generally agreed that reallocating resources in order to secure payments adjustment involves real resource costs which are larger the more frequent and the more sudden are the required adjustments. It follows that repeated adjustments to temporary disturbances, or forced precipitate adjustments (when these require a switch of resources rather than simply the elimination of excess demand), are wasteful. One of the objections raised in the C-20 to the reserve indicator proposal was that, to the extent that the proposal was not rendered otiose by capital mobility, it would have limited the ability of reserves to play their central and legitimate role of acting as a shock absorber to permit the stabilization of income and absorption. That objection remains applicable to the reserve indicator proposal considered in this paper. At the other extreme, the UNDP/UNCTAD proposal as incorporated in (C-4A) would have the effect of largely exempting countries from the need to adjust to temporary disturbances judged to be beyond their own control, and of allowing gradual adjustment to permanent changes beyond their control. It can be argued that this is exactly what would be needed to minimize adjustment costs, inasmuch as 'changes beyond a country's control' embrace virtually all causes of payments imbalances except domestic demand management policy, which is precisely the case in which remedial adjustment should be prompt. This proposal, and the version of the current balance targets proposal that incorporates it, should therefore be ranked highly on this criterion.

3. Appraisal

The above analysis suggests that there are some potentially powerful arguments for seeking greater coordination of economic policy than presently prevails. There is nothing in present arrangements to guarantee the absence of conflicting current-account objectives (at least in the short run), and such inconsistency could generate serious consequences. There is no mechanism capable of promoting consistent conjunctural policies, either of an activist Keynesian or of a monetarist steady monetary expansion type. There is nothing to give credence or form to a concerted world anti-inflationary policy. There is little reason to suppose that implicit current balance targets reflect appropriate levels of resource transfer to developing countries, and some reason to fear that the availability of capital may be arbitrarily interrupted. Countries continue to be faced with the need to make costly adjustments to temporary disturbances.

Although the above considerations are without doubt potentially

important, there is not at present any systematic evidence as to how significant they actually are. Various anecdotes have been cited above, but an exercise of judgment is indispensable in deciding whether these are sufficient to support a case for change. Would the world recovery have been materially aided if the surplus industrial countries had been clearly committed to targets involving appropriate current deficits, and exposed to financial penalties for substantial surpluses? Would the resulting higher level of demand have significantly reduced protectionist pressures? Is there scope for concerted world conjunctural and anti-inflationary policies? How much is wasted in excess adjustment costs by virtue of the absence of the UNDP/UNCTAD principle? Confident answers to such questions are not possible on the basis of present knowledge.

Answers can perhaps be given with rather more assurance about the distribution than about the magnitude of such benefits. All countries surely stand to benefit from better anti-cyclical policy, reduced adjustment costs, and so on. However, the developing countries would almost certainly stand to gain disproportionately, for the simple reason that they suffer disproportionately from the ills that the proposals are directed to remedying - world recession (with its effect on commodity prices), protectionist pressures (which characteristically impinge most heavily on the labour-intensive products that form the core of developing-country manufactured exports), the threat of arbitrary curtailment of borrowing possibilities, and excessively-abrupt adjustment (which tends to hit hardest the economies with the greatest structural rigidities).

It may also be worth summarizing some of the conclusions about the form that more structured coordination might take. The analysis suggested that rather modest results could be expected from a reserve indicator system (C-1). For essentially the same reasons (principally the growth in capital mobility), the UNDP/UNCTAD proposal alone might achieve relatively little except for the least creditworthy countries - while to the extent that capital mobility is sufficiently low to give the proposal potency, it would be subject to criticism as having an inflationary bias. However, as part of a system of current balance targets, the UNDP/UNCTAD principle could be expected to introduce a stabilizing bias rather than an inflationary bias. Stabilization policy could also be furthered by a set of DCE targets, which could be introduced either instead of or in parallel with current balance targets (see part (c) of C-3). ^{39/} The main technical difficulty presented by these proposals is that of selecting targets. There is a potential danger in any attempt to agree targets through international negotiations, in that the negotiating process may result in the imposition of unreasonably restrictive obligations. Many developing countries feel that this has in the past occurred with respect to the DCE targets agreed with the IMF in connection with stabilization programmes. On the other hand, it can be argued that the need to agree to uniform principles that would apply to all countries and would add up to a coherent sum for the world as a whole is precisely the discipline that is needed to make targetry a constructive exercise.

VI. Conclusions: the Range of Feasible Reforms

The purpose of this concluding section is that of evaluating which combinations of the preceding range of options would fit together to form logically-coherent and viable systems, and to offer some appraisal of which of those feasible reform packages could be expected to offer benefits to the developing countries.

1. The Present Arrangements

One viable combination is provided by the set of options that jointly define the present set of arrangements: (R-5), (V-3), (X-4), and (C-4). Whatever else may be said in criticism of existing practices, it can hardly be claimed that they are not collectively viable, and there seems little reason to fear a future collapse. The outstanding common feature of the existing range of practices, in comparison with all of the alternative options that have been examined in this paper, is that they lay down no ex ante rules that governments have to follow. Accepting to be bound by such rules could virtually be taken as a definition of what is meant by restricting national sovereignty. It can indeed be argued that world monetary arrangements have evolved to what they are now in large part because these arrangements are feasible without governments binding themselves and their successors (i.e. restricting their sovereignty). Although the point has not been stressed in the various 'Criteria for Evaluation' sections above, it needs to be appreciated that international monetary reform is a topic of interest exclusively to those who are prepared to contemplate limiting sovereignty on a reciprocal basis for sufficiently good reasons. The technical criteria discussed in the main body of the paper essentially address the question as to how good the reasons for limiting sovereignty may be.

2. The Internationalist Alternative

The combination of options that are at the opposite extreme to existing practices from the standpoint of the encroachments on national sovereignty is (R-4), (V-1), (X-3), 40/ (C-2), and (C-3). Both the link (R-4A) and the UNDP/UNCTAD Principle (C-4A) could also be incorporated, with advantage to the developing countries. This combination of the SDR as the unique reserve asset, vehicle currency and intervention currency, with the crawling peg and both current balance targets and DCE targets, has in fact been deliberately chosen as the most internationalist viable system that is compatible with the basic principle of the present global political order, namely division of the world into a series of sovereign nation states. Proposals for more extreme internationalist solutions, along the line of a world central bank issuing a single money to circulate throughout the world, can easily be imagined, but they would necessarily involve renunciation of monetary sovereignty by the individual nations.

Perhaps the most distinctive feature of an 'internationalist alternative' is that it would involve adoption of the international money, the SDR, for all monetary functions in both the official (reserve-currency) and private (vehicle-currency) roles. It will be recalled from the discussion in Section III.1 that general intervention in the SDR would be feasible only in the context of a return to a par value system, such as the crawling peg could provide. However, any par value system will be subject to speculative pressures, and it would be necessary to ensure that the system could survive these. This is a primary purpose of the DCE targets: the observance of these would both bring automatic monetary forces into play tending to counteract any speculative run, and provide assurance to creditor countries that they could grant whatever credit was necessary to the deficit country to finance the run without taking measures other than allowing the outflow to reduce the money supply, and without running the risk that a world monetary expansion would result from their granting of credit. There is every reason to suppose that a combination of the crawling peg, unlimited reserve credit, and a non-sterilization rule could eliminate speculative crises (Section IV.2(b)).

The 'internationalist alternative' embodies mechanisms to deal with all three of the classical triad of international monetary problems, those of adjustment, liquidity and confidence. So far as the adjustment problem is concerned, it embodies a specification of current balance targets to ensure consistency in the adjustment policies adopted by different countries, a non-sterilization rule to prevent errors in monetary targets having cumulative effects, a possible mechanism to limit deviations from target arising inadvertently from the cost side (in the form of the obligation to maintain the real exchange rate constant in normal circumstances), and two provisions as to what should be done to correct a medium-term deviation from the current balance target: (a) a 'real crawl' of the exchange rate in order to induce expenditure switching, and (b) a modification of the DCE target to provide supportive expenditure changing. Provided that the current balance targets are chosen reasonably, this represents a coherent package to deal with what many have judged to be the most intractable of all the problems of the international monetary system. With regard to the liquidity problem, it is true that the stock of official reserves might be altered by switches between national currencies and SDRs by the private sector, and that this would violate the aim of deliberate control of the reserve stock as pursued by the C-20. But the ultimate purpose of controlling world reserves was generally conceived as being that of controlling the world money supply - and this would be achieved directly by the DCE rule. (The reader may care to refer back to the T-accounts in Section III.1.) Finally, the confidence problem would be resolved by the single reserve asset embodied in (R-4).

There are two other issues worth posing with regard to the internationalist alternative. The first is, how real would monetary sovereignty be? One important respect in which monetary sovereignty would be preserved under this system but not under a world currency is in respect to withdrawal, which could be effected without domestic monetary dislocation. Second, unless the DCE targets were specifically

drawn to force convergence over time, countries would be able to perpetuate independent national rates of inflation. Third, countries would have some (albeit limited) freedom to pursue a conjunctural policy of their own choosing: fiscal policy would be available for this purpose, there would be a range within which a country could select its DCE without penalties, and a government which believed that its DCE target was inappropriate could in the last resort go its own way and pay the prescribed penalties. If the rules are sensibly drawn and interpreted, one would expect the occasions for such defiance to be rare; in practice the opposite danger, that the rules might be too readily interpreted to say what each government wants them to say, might be greater. It would be utterly wrong to pretend that DCE targets could mean anything unless they circumscribed monetary sovereignty, but there is a world of difference between that circumscription and the total renunciation of monetary sovereignty implicit in a monetary union.

The final question worth asking is whether such a system should be envisaged as relevant only for the countries at the core of the international economy, or whether the developing countries should also be included. It is surely true that the major gains from exchange-rate stability and improved coordination depend overwhelmingly on the participation of the principal industrial countries and only marginally on that of the developing countries, and it would therefore be difficult to justify a policy of attempting to coerce the latter into participation against their will. On the other hand, participation would itself bring certain benefits, such as credibility regarding exchange-rate commitments and extensive credit facilities. It would be outrageous if these advantages were to be denied to developing countries that were prepared to accept the corresponding obligations. A natural solution to this question would be to actively seek the participation of the major countries, and to provide that beyond that membership would be available to any country that was prepared to accept the obligations.

3. Variations on the Internationalist Alternative

This section will consider which of the options in the internationalist alternative could be withdrawn or modified without jeopardising the objective of establishing the SDR as the basic reserve asset and vehicle currency.

Consider first the question of reserve regime: would it be possible to establish the SDR as the basic reserve asset without going all the way to an SDR system in which countries agreed to hold all of their reserves in SDRs at the IMF? This would no doubt be mechanically possible: some countries could hold a small part of their stock of reserves in national currencies or Euro-SDRs without making the system unworkable. However, allowing exceptions would raise policing problems absent from the extreme proposal. It would also tend to undermine some of the purposes of the system, such as establishing control of the global money supply. Finally, given the intervention currency role of

the SDR and a guaranteed competitive rate of return, it seems unnecessary.

Consider next the exchange-rate regime. It was argued in Section III.1 that reconciliation of the basket valuation of the SDR with a vehicle-currency role for the SDR demanded a par value system; hence the only alternative available here is to drop the limitation on the size of change in the exchange-rate peg, i.e. to move from the crawling peg to the adjustable peg. The problem this would raise is, of course, that of disequilibrating capital movements, which one could no longer rely on being able to keep under control with a non-sterilization rule. It has been argued (III.2b) that the effects on third parties of speculative capital flows might be eased by adoption of the SDR as a vehicle currency, but that would not be likely to be enough in itself to make the system viable. The essential additional element would be a set of effective capital controls. Past experience regarding the possibility of implementing such controls is not particularly encouraging.

Finally, consider whether either or both current balance and/or DCE targets could be abandoned without destroying the system. While neither of these are mechanically indispensable, it seems rather unlikely that the system could function satisfactorily without something in the nature of DCE targets. These would be important in providing reassurance to 'stability-minded' countries that they could participate in a pegged-rate system without an open-ended commitment to import inflation; in establishing control over world credit expansion; in reinforcing the adjustment process and perhaps in promoting conjunctural policy; and in backing up the credibility of a non-sterilization rule (though this would not be important in a system with effective capital controls). Current balance targets would be less central to the operation of the system: their roles are to provide guidance to changes in real par values, and (especially in conjunction with the UNDP/UNCTAD principle) to promote conjunctural policy. They could, therefore, probably be dispensed with.

4. Minimal Reforms

There no doubt exists a possibility that, however great the technical merits of the internationalist alternative might be judged to be, it will not be found politically acceptable because of the limitations on national sovereignty that it would require. The present section therefore considers which of the various options discussed in the paper and judged desirable from the standpoint of the developing countries could be introduced independently.

So far as the reserve regime is concerned, by far the most important reform remains that of introduction of the link (R-4A). In addition, there might be some advantage in the establishment of a substitution facility (R-5B), if the terms were appropriate.

It was argued in Section III that it would be possible for the developing countries to make a collective unilateral move to adopt the SDR as vehicle currency (V-2). This would be a bold move, but it is one that would merit serious consideration if the developed countries continue to take a negative attitude to substantive reform.

In regard to exchange rates, two questions arise - whether it would be possible to return to a pegged-rate system without complementary reforms, and whether the floating system could be improved. It is perhaps natural for developing countries, most of whom have judged that the best policy for themselves is to continue pegging even in the present situation, to assume that all that is needed to enable the developed countries to do the same is goodwill. This is doubtful - not only because most developed countries are more exposed to the buffeting of speculative flows than are most developing countries, but also because the major industrial countries find it less natural to accept a 'small country' role in the world economy than individual developing countries do. To restore a system of pegged rates without complementary reforms would essentially take the world back to the acute asymmetries of economic power of the post-Smithsonian dollar standard. The principal demand of the industrial countries (other than the United States) in the C-20 was precisely the elimination of those asymmetries, through the instrument of asset settlement. The asymmetries would also be eliminated in the internationalist alternative, through the medium of the SDR standard. Where pegged exchange rates have survived among the industrial countries, within the European Community, there are careful settlement arrangements to limit asymmetries emerging. It seems unlikely that these perceptions of what is important will disappear.

Limited reforms would therefore have to consist of codifying intervention policies for floating currencies, along the lines of (X-1A), leaning against the wind, or (X-1B), target zones. In so far as a cause of exchange-rate volatility (and indirectly of poor macroeconomic management, see IV.2d) is the unpredictability of government policies by the exchange markets, either proposal might help. It was argued in IV.2a that the target zone proposal would probably be the more helpful in reducing instability, provided at least that the target zones were published.

It would be possible to move toward more structured arrangements for the coordination of economic policy independently of any other changes in international monetary arrangements. For reasons already stated (Section V.2), not much might be gained by a reserve indicator system. However, there is no reason to suppose that current balance targets would be any less effective in an environment of laissez-faire than under a structured system, and reasons were mentioned in Section V.2a for thinking that they might have played a useful role in recent years. Another reform that could be grafted on to the present system independently is the UNDP/UNCTAD principle. There are, however, two reasons for considering introducing current balance targets and the UNDP/UNCTAD principle as a package: one is that current balance targets would help ensure that the UNDP/UNCTAD principle had a

stabilizing bias rather than an inflationary bias, the other is that the UNDP/UNCTAD principle would make current balance targets a far more potent instrument of anticyclical policy than would otherwise be the case.

The other option in this area was DCE targets (C-3). Although the case for coordinating DCE is less compelling in the absence of an intention to peg exchange rates, it can be argued that there is still a good case. 41/

It might be possible to move tentatively and experimentally toward adoption of current balance or monetary targets. For example, the IMF might be instructed to work out what it thought would be appropriate targets, and to include these in its assessments of world economic prospects, without in the first instance committing countries to follow them. If and when a consensus developed that the targets were sufficiently well-conceived to create a presumption that world economic performance would be enhanced by countries adhering to them, it might be possible to create inducements less compelling than formal financial sanctions. For example, the IMF might adopt a practice of extending first credit tranche conditionality to drawings in higher credit tranches on the part of countries with an exemplary record of achieving their target current balances.

5. Concluding Remarks

The reforms of present international monetary arrangements that have been considered in this paper vary from the ambitious and comprehensive reform labelled the 'internationalist alternative' to a series of minimal reforms, the most important of which might be implemented by the developing countries acting in unison but independently of the developed countries. If developing countries believe that present international monetary arrangements are basically unsatisfactory, and are prepared to accept the fact that more structured arrangements will necessarily imply some limitation of national sovereignty, there are ways in which they could take an initiative to change things through either comprehensive or piecemeal reform, working either with or independently of the developed countries.

FOOTNOTES

* The author is greatly indebted to the members of an Expert Group convened by UNCTAD to discuss a previous version of this paper for their many valuable comments. Responsibility remains that of the author alone.

1. Each option is identified by a code consisting of an initial letter indicating the topic ('R' for reserves, 'V' for vehicle currency, 'X' for exchange rates, and 'C' for coordination), followed by a number to identify the option and, in some cases, by a further letter (from A to C) to indicate a variant.
2. Williamson (1973, Section III.2).
3. Williamson (1980a).
4. The term 'viscous' to describe an exchange-rate system is due to President Giscard d'Estaing. It is interpreted here to refer to systems in which significant exchange-rate changes require deliberate decisions that changes are appropriate.
5. Thereason that developing countries tend to get proportionately larger benefits from SDR allocations than do developed countries is that the interest rates they otherwise have to pay in order to borrow are in general higher. But it should be noted that many developing countries feel that their IMF quotas are disproportionately small; to the extent that this is true, it cannot be concluded that their total benefits from SDR allocations are greater than 'neutral'.
6. For example, Chrystal (1978) and Helleiner (1980).
7. Triffin (1960).
8. Floating is not in general a viable option for developing countries, because of the shallowness of their exchange markets. For both theoretical analyses of this question and accounts of the experiences of developing countries that attempted floating, see Williamson (forthcoming).
9. A special case of the target zone proposal is the 'reference rate proposal', in which central banks would be committed not to buy a currency appreciated above its target zone nor to sell one depreciated below its target zone. See Ethier and Bloomfield (1975) or Williamson (1977, Ch. 8).
10. There is evidence from South American experience, where adoption of the crawling peg substantially reduced the variability of real exchange rates, that exchange rate uncertainty does indeed have this expected effect. See Coes (1979).
11. See, for example, Artus (1976, pp. 328-9), Black (1977, pp. 163, 168-9), or Dornbusch (1980).

12. Williamson (1977, Ch. 8).
13. Katz (1953).
14. An attempt to document this increase in capital mobility was made by the author in (1977, pp. 46-50).
15. Thygesen in Triffin (1979).
16. IMF (1974, p. 85).
17. Carse, Williamson and Wood (1980, Ch. 6).
18. Carse, Williamson and Wood (1980, Ch. 6); or McKinnon (1979a, Ch. 7).
19. Friedman (1953).
20. Artus (1976, p. 327).
21. Small differences may be necessary to compensate for different growth rates, different intersectoral productivity trends, and different income elasticities of demand for exports and imports.
22. See especially Goldstein (1977). But note that Goldstein's tests sought asymmetries only in prices, given wages; whereas the more likely source of asymmetry may well be in wage behaviour. Recent unpublished work of Peter Kenen which is not subject to this limitation has found weak evidence of the postulated asymmetry.
23. McKinnon (1979b), Bruno and Sussman (1979).
24. Bruno and Sussman (1979).
25. Williamson (1980b).
26. See, for example, Ball, Burns and Laury (1977), or Robinson, Webb and Townsend (1979).
27. This formula is developed in Williamson (1979).
28. For amplification see Williamson (1979); and for critical appraisals see Williamson (forthcoming).
29. Triffin (1964).
30. A reserve indicator system with teeth would accomplish essentially the same objective as asset settlement provided it were based on net reserves.
31. A variant on this option would be a set of Basic Balance Targets. The idea is to allow countries current account imbalances provided these can be financed by long-term capital flows. However, since the proposal for Current Balance Targets has been formulated to allow current imbalances under appropriate circumstances rather than requiring current balance, the difference in principle

between the two options would be minimal. Moreover, the basic balance has now become a largely meaningless statistical measure, mainly because of the ambiguity as to whether Eurodollar rollover loans should be classified as long-term or short-term.

32. See the discussion of option (C-4A) below.
33. For example, McKinnon (1974); also Williamson (1980a).
34. UNDP/UNCTAD (1979, Recommendations (iv) and (x)).
35. The basic argument is that, while reserve accumulation and DCE are complements under fixed exchange rates, they are substitutes under flexible rates. See Williamson (1980a).
36. See Corden (1978).
37. Williamson (1978).
38. The phrase 'full employment' is used here to indicate a target pressure of demand which reflects the need to control or reduce inflation. It is therefore closer to the concept of the 'natural rate of unemployment' than to unemployment of, say, 3 per cent.
39. At least under certain circumstances, it would be improper to penalise countries financially for deviations from both current balance and DCE targets. For example, in a system like the 'internationalist alternative' of Section VI, where changes in real exchange rates would be guided by deviations from current balance targets, it would be wrong to penalise countries which followed the exchange rate and DCE rules for violating current balance targets, since that would reflect little more than random factors.
40. The crawling peg imposes a more severe limitation on sovereignty than the adjustable peg inasmuch as it restricts the changes in the peg that a country can make.
41. Day (1979).

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EURO-CURRENCY MARKET REGULATION: ITS POTENTIAL EFFECTS ON THIRD WORLD ACCESS TO THE MARKET

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I. Introduction

1. Since the early beginnings of the Eurocurrency markets, monetary authorities and other observers of the international financial scene have expressed concern over its potentially disturbing effects on international financial stability. Even in the days when outstandings in the market amounted to no more than a few billion dollars, some central bankers suggested that the succession of interdependent short-term claims characteristic of the market implied ignorance of original lenders about the ultimate borrowers and their ability to meet their obligations. This, so the argument went at that time, imposed a new element of vulnerability to the international financial system.

2. As the market broadened and Euromarket deposits in the late sixties began to approach \$100 billion, the concerns escalated. Central banks became aware that the market was significantly affecting the availability of credit in their domestic markets. They noted that their attempts to restrict credit expansion were often undermined as their banks, by drawing on the market, obtained additional funds for credit extensions to domestic borrowers. Often these borrowers themselves were able to escape monetary policy constraints by obtaining loans in foreign or local currency from banks abroad that acquired the underlying balances in the Eurocurrency market. Central banks discovered that banks would substitute foreign currency loans - mostly denominated in dollars - for local currency loans to some customers and thereby free local currency resources to meet the need of other borrowers who should not have been fully accommodated in the light of prevailing credit policy. They noted, moreover, that Eurocurrency market transactions were importantly affecting other variables of great concern to them - interest rates, spot and forward rates for foreign exchange, monetary reserves and the international balance of payments.

3. As the years went by and the market continued to expand by leaps and bounds, the initial concerns broadened and gave rise to increasing fears and in some circles to alarmist, and in some cases almost hysterical accusations, based on deepseated misconceptions of the workings of the market. The market began to be blamed and held responsible for virtually all the major ills of the world's financial system - world-wide inflation, international exchange rate instability and "reckless" borrowing by both developed and less developed countries

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under balance-of-payments pressures. Such countries were alleged to take the easy way out of whatever ailed their economies by taking advantage of the ample availabilities of Eurocurrencies, especially Eurodollars. Increasingly, the market was viewed, even by some responsible and knowledgeable authorities, as an international engine of inflation, a "vast atomic cloud of footloose funds", a resting place for large amounts of "stateless" money with the potential for inflicting grave damage to the international economic system.

4. Even authorities, not partaking in these extreme views, became worried over the soundness of Eurobank operations as they reached ever growing magnitudes. They became concerned over potentially excessive exposures of Eurobanks in countries that may be forced to reschedule their debts, if not repudiate them. Some pointed with some alarm to the inadequacy of Eurobank earnings resulting from the low spreads between the rate banks must pay for funds and their lending rates. They began to worry over the poor returns earned by these banks on their capital and the inadequate compensation, implied by the low spreads, for lending at distant maturities to developing countries with uncertain balance-of-payments prospects.

5. All these concerns in varying degrees have played a role in producing a broad consensus among OECD central bank governors regarding the need for exploring approaches to a greater degree of Euromarket regulation and supervision. In May 1979, at their regular meeting at the Bank for International Settlements, they agreed that the problem of Euromarket control which had been recurrently discussed by the Standing Eurocurrency Committee of the BIS should be re-examined. Another Committee, chaired by Mr. Lamfalussy, the Economic Adviser of the BIS, together with a sub-committee, was to look into various control devices. Still another Committee which had been meeting regularly for a number of years under the auspices of the BIS, the Committee on Banking Regulations and Supervisory Practices, under the chairmanship of Peter Cooke, a Bank of England official, was requested to continue its efforts to strengthen prudential supervision of the market on an internationally coordinated basis. After several meetings during the fall and winter of 1979/80, the Lamfalussy Committee submitted its recommendations to the OECD governors. In April 1980, the governors issued a communiqué in which they outlined their views on the need for closer monitoring of the Euromarket. The major purpose of this study is to evaluate the likely impact of this new policy approach on the market's capacity to provide additional loans to Third World countries. The study will also review various proposals for Euromarket control that were rejected by the governors, but which may well surface again in future years.

II. Views on the Rationale of Controls

6. Agreement among the central bank governors that a greater degree of supervision of the Euromarket is called for does not mean that they agree on the alleged threats of the market to international financial stability. In fact, most of the governors appear to feel - and with good reason - that the intellectual underpinnings of the need for tight

controls remain quite weak. This awareness has important implications for the ongoing and future debate on controls and regulations. Reservations with respect to the rationale of controls tend to make their proponents proceed cautiously and with restraint. A conservative attitude toward control and regulation is also supported by the general awareness among policy makers of the great contributions of the market to the financing of the international economy, the expansion of world trade, the recycling of OPEC surpluses and the financial needs of developing countries. Altogether, they do not wish to hobble the market, though they appear to be persuaded that a continuation of its rapid growth poses problems and they, therefore, wish to see its growth rate come under some degree of restraint. Governor Gordon Richardson of the Bank of England has said that anything that grows by 25 per cent each year bears watching. Former Bundesbank President Emminger recently added that something needs to be done to moderate the pace of the market's expansion. These statements pretty well reflect the general feeling among the majority of OECD governors.

7. The growth of international bank lending, whether via the Euromarket or via traditional domestic currency lending, has indeed been breathtaking, whatever measurement of such lending is employed. The various statistics on this subject are unfortunately quite confusing as they pertain either to the gross size of the market as measured by the BIS or to the net size which the BIS estimates by excluding double counting due to the redepositing among reporting banks. Some of the statistics pertain solely to foreign currency deposits and loans, i.e. Euromarket operations; others also include domestic currency deposits and loans such as dollar loans by U.S. banks. Then allowance needs to be made for the incompleteness of statistics on deposits and loans out of so-called offshore locations. These statistics typically include only deposits and loans made by the branches of U.S. banks. And then there are the effects of the depreciation and appreciation of the U.S. dollar which ipso facto expand or reduce the dollar value of non-dollar loans. Some non-official institutions, notably the Morgan Guaranty Trust Company, have developed more comprehensive statistical series on Euromarket activity than the BIS which uses only official statistics and neglects Eurocurrency supplies not reported by some official agencies. There are also statistics on recorded medium-term loans out of the Eurocurrency market, some of which reflect refinancings. Virtually all statistics have important shortcomings. But whatever measurements are used, the growth of international bank lending has been huge. One needs to mention only one statistical series that is widely used, i.e. the estimated dollar value of the net external assets in domestic and foreign currencies of the banks in the Group of Ten countries, Luxembourg and Switzerland, of the branches of U.S. banks in offshore centres, and since the end of 1977 of banks in Austria, Denmark and Ireland. This series shows outstanding net international bank credit to have amounted at the end of September 1979 to no less than \$635 billion against \$170 billion at the end of 1973 and \$330 billion at the end of 1976. Or take recorded medium-term Eurocredit. In 1978, it rose by \$57 billion and in the first three quarters of 1979 by \$46 billion.

8. These are certainly impressive growth rates. However, if set against the growth of world trade or current account deficits the

financing of which is one of the major functions of the Euromarket, its growth does not appear excessive. For example, as recently pointed out by Warren D. McClam, Deputy Manager of the BIS, world imports rose in absolute terms from just under \$300 billion in 1970 to \$1,230 billion in 1978, while the Eurocurrency market increased on a net basis from about \$65 billion to some \$540 billion.^{1/} Mr. McClam also related the market's growth from 1973 onwards to the sharp widening in the aggregated current account imbalances for the world as a whole. He has shown that the Euromarket has since the early seventies grown approximately in unison with the gross current imbalances of the OECD countries. Nevertheless, the growth of the market in absolute terms has been so rapid that monetary authorities and bank supervisory agencies have come to the conclusion that it may give rise to potentially undesirable exposures for individual banks and eventually tend to undermine the stability of the international banking system. This concern has been reinforced by fear that political crises of the sort that have occurred, or could occur, in certain major lending and/or borrowing countries could give rise to wholesale withdrawals of deposits from the market and produce a liquidity squeeze affecting not only the affiliates and branches of major banks active in the market, but also the parents themselves. And quite apart from political disturbances, inability of some of the countries to meet their debt service obligations as a result of major setbacks in the world economy could bring in its train threats to the solvency of lending institutions.

9. Another prudential concern relates to the dramatic decline in the spreads over costs of Eurocurrency funds charged by banks to borrowers in the syndicated Euromarket and the simultaneous extensions of maturities to ever more distant dates. Supervisory authorities in the OECD countries fear that the spreads no longer cover adequately the risk premium that should be charged to produce loss reserves, not to mention the banks' capital costs to be assigned to individual loans. Indeed, spreads declined considerably last year, dropping from 1.52 per cent to less 3/4 per cent on the average in the period January-September 1979. Moreover, non-interest charges such as management and agency fees also came under pressure to such an extent that aggregate earnings on syndicated loans in 1979 probably only barely covered out-of-pocket and overhead operating costs.^{2/} There is also fear that mismatching of maturities on assets and liabilities in the market has gone too far, considering the extreme volatility of interest rates in recent periods and their rise to entirely unexpected and unprecedented levels. To the extent that international loans carry floating rates, maturity transformation is of little concern. But there is evidence of a serious worsening in the coverage early in 1980 of short-term Euromarket liabilities by equivalent term assets. It is these prudential concerns that are very much in the minds of the governors of the OECD central

^{1/}See Warren D. McClam: U.S. Monetary Aggregates, Income Velocity and the Eurodollar Market - BIS Economic Papers No.2, April 1980.

^{2/}During 1980 spreads and non-interest charges applicable to loans to developing countries have increased significantly once again, but have tended to narrow further for borrowers in industrial countries.

banks, quite apart from the macroeconomic effects of the rapid growth of international bank lending.

10. Looking at the market in a broader perspective, these concerns disregard or at least fail to make proper allowance for several countervailing considerations of great significance to the financial authorities in developing countries. The major developing country borrowers can point to their excellent record in meeting their contractual payments on Euromarket borrowings - a record that justifies low risk premiums. Moreover the contraction of spreads and other fees until recently limited the growth of the debt servicing burden of developing countries and thereby eased significantly the pressure on their balances of payments. One should also bear in mind the impressive economic growth rates of a number of developing countries, and the associated rise in their export earnings which have been made possible by their resort to the Euromarket and which justify a rapid increase of their external debt.

11. Among United States monetary policy makers, concern over Euromarket developments have taken an entirely different direction. They have focused on the implications of the market's growth for the efficacy of monetary policy, an approach that led them to demand a much greater restraint on Euromarket growth than most of their European colleagues have been willing to support. At the May 1979 meeting of the BIS governors, former Federal Reserve Board Chairman G. William Miller called for Euromarket control in the interests of fighting world inflation, and launched a vigorous campaign in favour of reserve requirements on Eurodollar deposits. Following Mr. Volcker's assumption of the chairmanship, Federal Reserve Board Governor Wallich continued this campaign with great determination in a series of speeches and articles as well as in Congressional testimony. Governor Wallich suggests that the Euromarket poses serious problems for monetary policy largely because liabilities to non-banks are rising at a much more rapid rate than domestic money supplies. He concedes that these problems have been of only moderate significance to date, but claims that they are increasing. There is the risk, he suggests, that over time as the Euromarkets expand relative to domestic markets, control over the aggregate volume of money may increasingly slip from the hands of central banks. Thus, in his view, the existence of Euromarkets confronts domestic monetary authorities with a dilemma. If they were to focus exclusively on domestic aggregates, ignoring the effects of the more rapid growth of liabilities to non-banks that is occurring in the Eurocurrency markets, they would facilitate more expansionary and more inflationary conditions than they intend or may be aware of. Theoretically, he says, this rapid expansion of money supplies in the Euromarkets could be offset by tighter Federal Reserve policies acting on the domestic money supply. Thus Governor Wallich has raised the unpleasant spectre of the U.S. monetary authorities and perhaps other central banks exerting greater monetary pressure on the domestic market in order to offset the expansionist effects of the uncontrolled Euromarket. Therefore, he has argued, it would be prudent to have available instruments for controlling the Eurocurrency market as there are for controlling the domestic aggregates. This, in his opinion, is one of the principal reasons for seriously considering the need for

reserve requirements against Eurodeposits on an international basis. While the majority of central bank governors do not consider the alleged threats posed by the Euromarket to the efficacy of monetary policy as particularly urgent, there is little doubt that Governor Wallis's campaign influenced the deliberations of the BIS committees and the decisions of the governors.

III. The New Approach to Euromarket Supervision

12. Following extended discussions during the fall and winter of 1979 in the committees set up at the BIS and the submission by the BIS staff of recommendations to the central bank governors of the Group of Ten countries and Switzerland, the governors issued in April 1980 a communiqué in which they set out in some detail their policy approach to a closer supervision of international bank lending whether through the Euromarket or through other channels.^{3/} At the outset, the communiqué noted that international bank lending aggregates had been expanding at an annual rate of some 25 per cent and that the recycling of the large OPEC surpluses would lead to further substantial growth of these aggregates. In view of this, the governors decided to strengthen regular and systematic monitoring of international banking developments, with a Standing Committee on Euromarkets reviewing the international banking statistics of the BIS and reporting to the governors at least twice a year. In recognition of the possibility that the international banking system might be exposed to greater risks than in the past, the governors reaffirmed the importance that they attached to the maintenance of sound banking standards - particularly with regard to capital adequacy, liquidity and concentration of risks.

13. The cornerstone for maintaining these standards, according to the communiqué, is the bringing into full effect of the initiatives already taken by the BIS Committee on Banking Regulations and Supervisory Practices, mentioned in paragraph 5 above. This Committee, composed of representatives of the G-10 countries plus Luxembourg and Switzerland, has met regularly for several years to assess the quality of government oversight of the international banking system. Its major initiative, referred to in the communiqué, has been the obtaining by national banking authorities of complete information from banks on cross-border exposure of their branches and subsidiaries through a consolidated balance sheet approach. Other initiatives of the committee that were specifically referred to in the communiqué have been improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

14. The communiqué conceded that differences in competitive conditions between domestic and international banking that arise out of official

^{3/}The text of the communiqué is reproduced in the appendix to this report.

regulations and policies had stimulated growth of international bank lending in general. It emphasized that transactions channelled through the Eurocurrency market could pose problems for the effectiveness of domestic monetary policy in those countries where such differences are particularly significant. Because of this, the communiqué said, efforts will be continued to reduce the differences of competitive conditions, but no particular measures were recommended. In other words, no drastic action to impair the functioning of the Euromarket is presently in prospect.

15. The communiqué does not refer to a series of proposals discussed extensively by the BIS committees during their re-examination of the problems of Euromarket regulations and supervision, but it reflects the rejection by the majority of the BIS committee members of these proposals. Since some of these proposals may nevertheless be put forward again, they are discussed in some detail below. Among these proposals were the following:

- (1) Deposits and credit ceilings in the form of maximum limits on the rate of market expansion.
- (2) Limits on the deposit of official funds.
- (3) Reserve requirements for the purpose of reducing the profitability of Eurocurrency operations.
- (4) Capital and liquidity ratios for Eurobanks.

16. The first two of these proposals produced very little interest among committee members. Deposit and credit ceilings on Eurobanks were considered as impracticable or undesirable. It is true that many countries have, in fact, used such instruments domestically, and the Federal Reserve System employed credit ceilings in its Voluntary Foreign Credit Restraint Programme. Objections to this method of market control are, however, deep-seated. Either the quotas are based on past behaviour, a process which tends to freeze existing competitive positions, or they call for administrative decisions which often involve inequity. In either case, there is a loss of market-stimulated gains in efficiency.

17. The proposal for limits on official deposits builds on the agreement adopted by the Group of Ten countries in 1971, providing for limits on their placements in the Euromarket. The proposal's rationale derives from the fact that the placement of such deposits is clearly expansionary since the reserves of the countries that borrow the funds tend to rise while those of the lending country do not decrease. During the deliberations of the Committee on Reform of the International Monetary System (the Committee of Twenty) this proposal was put forward, but was rejected by the central banks of the developing countries. For a variety of reasons, the latter have found the Euromarket a preferred outlet for their monetary reserves. One reason is the anonymity of the market; another is its relatively high rate of return. Developing

countries have found it useful to put balances in Eurobanks in compensation for loans by these banks or as inducement for such loans, often upon request of the lending institutions. More recently, the fact that the Euromarket provided access to reserve holdings in "strong" currencies has been a major factor in the desire of monetary authorities to place funds in the market. The BIS committees recognized that in the light of the compelling arguments of the central banks of the developing countries in favour of the continued use of the market for the investment of their monetary reserves, there was virtually no chance of persuading them to follow the example of the OECD countries. Thus the proposal was dropped.

18. Much of the time of the BIS committee that studied possible approaches to Euromarket controls was taken up by the above-mentioned proposal of former Federal Reserve Chairman Miller and Governor Wallich that deposits in Eurobanks be made subject to reserve requirements. A subcommittee chaired by Steven Axilrod, a staff officer of the Federal Reserve Board, prepared a detailed report on the merits of internationally coordinated reserve requirements and submitted the outline of a comprehensive system under which the OECD central banks and the Swiss National Bank would place reserve requirements on the Eurocurrency liabilities of their banks' head offices, branches and banking affiliates, no matter where located. Deposits accepted from banks that were subjected to the requirement would be exempted. The objective would be to slow the growth of the Euromarket by putting the Euromarket more nearly in a position of competitive equality with domestic banking markets.

19. The response of the majority of central bank representatives in the BIS committee to this proposal was quite negative, though it received qualified support from the Federal German representatives. Several central bank representatives as well as the BIS staff expressed great doubt that reserve requirements, apart from making Eurolending somewhat more expensive, would materially restrain the growth of the market. They considered the costs of establishing such a system not worth the effort in view of the likely impact of the modest reserve requirements proposed and thus considered them impracticable. Their reservations were also prompted by the fact that with the exception of the United States and the Federal Republic of Germany, the countries represented at the BIS either had very low reserve requirements on their own banks' deposit liabilities or no reserve requirements at all. Moreover several countries pay interest in one way or another on reserves held in their central banks. The majority of committee members were convinced that there is little prospect of convincing the authorities that do not now impose requirements to change their legislation and of persuading countries that have relatively low requirements to raise them. Moreover, much doubt was expressed as to the practicability of getting countries to agree that reserve requirements should apply to external currency deposits in various denominations held in branches and affiliates of their banks located abroad. These doubts were reinforced by the fact that some central banks do not have the legal authority to impose reserve requirements on the foreign branches and subsidiaries of their nations' banks.

20. While there was recognition that the absence of reserve requirements on Eurobank deposits has contributed to the growth of the Eurodollar and Euro-DM market, it was widely felt among the committee members that it was up to the United States and Federal German authorities themselves rather than to the authorities of other countries to reduce competitive disparities between their own markets and the Euromarket sector. One such approach would be to pay interest on reserves held in the Federal Reserve banks; another would be to reduce, if not eliminate, reserve requirements on CD's, time deposits and savings deposits and confine reserve requirements to transactions balances. Another major step toward lessening the disparities between the U.S. money and Eurodollar market would be to eliminate the Federal Reserve regulation prohibiting the payment of interest on deposits with a maturity of less than 30 days. Arguments of the U.S. representatives that such measures would give rise to objections by the Congress and various interest groups in the U.S. made little impression on their colleagues. The latter saw no need to accept highly complex and elaborate institutional changes in their own legislation and tools of monetary policy because of the inability of the U.S. authorities to remove archaic provisions in their own laws and regulations.

21. Capital adequacy requirements, taking the form of a set of required capital to loan ratios, has been the technique of Eurocurrency market growth restraint supported by several members of the BIS committees. In their view, such requirements would tend to enhance the soundness of international banking, slow down lending to a more sustainable magnitude and induce banks to raise spreads over the deposit rate. Moreover, this approach would find support in the banking community and thus attract their cooperation. In view of the widespread support for capital to loan ratios and the likelihood that their application will become more common among supervisory authorities, they deserve some further comment in the present study, even though an agreement on a uniform level of ratios appears presently beyond the reach of central banks.

22. The proposal gives rise to grave technical difficulties, primarily because capital ratios presently employed in various countries differ greatly. This reflects partly differences in accounting practices and in the extent of balance sheet consolidation. A ratio that is quite low by the standards of some countries would be considered high by other countries. There is simply no generally accepted measure of adequacy of capital-loan or deposit ratios. Adoption of uniform standards is also complicated by the fact that the supervisory authorities define capital and reserves in different ways. Views differ with respect to the treatment of contingency reserves as well as fixed assets. Some countries include subordinated debt in capital. Others make allowance for hidden reserves, except depreciation and amortization reserves. Still others are inclined to apply less stringent ratios to offshore loans than to domestic loans. Then there is the problem of trust assets, held in very large amounts by the Swiss banks. If they were included in lending limits, they would reduce the foreign asset holdings financed with direct liabilities of the respective banks.

23. Some broader reservations about the usefulness of capital-loan

ratios are also quite widespread among authorities that have studied their application. They have come to the conclusion that even where such ratios are high, they by no means safeguard bank liquidity. Such ratios make no allowance for such important factors as management performance, liquidity of assets, earnings performance, and the quality of operating procedures, to mention only a few. Furthermore, capital adequacy standards do not provide any assurance that banks will be able to withstand abnormal losses arising, say, from a deep economic crisis. The level of capital in individual banks cannot be adequate if loans to major borrowers must be written off because of an international political or economic crisis.

24. The expectation, moreover, that capital ratios will slow the growth of the Euromarket rests on very slender grounds. At best, capital ratios, if universally adopted, would constrain the bank demand for Eurocurrencies to some indeterminate extent and may therefore possibly lead to some decline in the premium on rates in the Eurosector of the money market for specific currencies relative to their rates in domestic money markets. Suppliers of funds to the Euromarket may thus find domestic money markets more attractive, considering the sovereign risk premium on which they often insist for their Eurodeposits, or they may purchase government securities and other money market securities instead of making deposits in the Euromarket. But such preference shifts are by no means a foregone conclusion. What could happen is that banks with adequate capital ratios may enlarge their share of the Euromarket at the expense of those with inadequate ratios. There is the possibility, however, that to the extent that supervisory agencies relate loans to a particular country to the lending bank's capital, the emphasis on capital ratios could make access of individual borrowers or borrowing countries to the Euromarket more difficult and thus change its borrowing country composition, though not the quantity of Eurolending.

IV. The Outlook

25. The fact that none of the major Euromarket control proposals under review in the BIS Committees were accepted by the OECD governors does not mean that the market's growth will remain unhampered. It is evident from the BIS communiqué that the governors have high hopes that prudential supervision of the market on an international basis will temper the market's rate of growth. They evidently expect that the quality of bank lending will gain from a strengthening of supervision over the assessment and pricing of country risks by banks involved in international lending. There is an implication in the communiqué to the effect that such supervision will slow lending to developing countries heavily indebted to individual banks.

26. The major responsibility for the future official direction of the Euromarket will fall upon bank supervisory authorities under the guidance of the BIS Committee on Banking Regulations and Supervisory Practices. The governors appear to anticipate that the bank supervisory authorities will be made more responsive to the macroeconomic policy objectives of their governments and central banks.

27. In its future work the Committee is likely to suggest that the individual supervisory bodies be guided by the United States system of bank supervision in strengthening their supervisory approach. In the United States, the supervisory authorities employ consolidated balance sheets for a systematic assessment of the risk exposure of individual banks. The adequacy of diversification within each bank is determined in the light of information on the borrowing countries' financial position. Individual country risk exposures are related to the banks' capital. Supervisory authorities do not classify particular borrowing countries as involving excessive risk, except in cases where there has been an interruption of payments or such an interruption is deemed imminent. However, in reviewing an individual bank's foreign activities, an examiner may conclude that certain exposures appear excessive in the light of the position of the bank.

28. It appears likely that in several countries the adoption of the U.S. procedures will be resisted. Few countries have a systematic examination method of the kind long established in the United States. In some countries, supervisory authorities appear not to be very eager to impose their own judgment on exposure concentrations of their commercial banks. They feel that the banks are in a much better position to make such judgments. In any case, the new decisions of OECD central bank governors will give further impetus to expanded reporting requirements for banks on an internationally coordinated basis and thereby throw light on the operations of the Euromarket and on international bank lending in general.

29. It seems likely that the international banking community will become increasingly cautious in its lending decisions. It is well aware that its lending activities will become more and more subject to the critical and cautionary review of supervisory authorities. This perception will affect lending policies. Moreover, this perception coincides with the present trend among bank managements and their boards of directors towards correcting undue risk concentrations in their loan portfolios. As a consequence, some of the developing countries that are heavily indebted to international banks may find it increasingly difficult to obtain adequate funds in international banking markets and may be forced to offer generous terms and conditions to the decreasing number of potential lenders with still ample lending potential.

30. Superimposed upon the desire of international banks for a greater measure of risk diversification is the greater degree of sensitivity to political risk considerations among lending banks. Political disturbances in various parts of the world have added to this sensitivity. This cautionary attitude is shared by supervisory agencies. It will affect lending to countries where political prospects are viewed with concern by the international financial community.

31. The prospective strengthening of prudential controls, together with a growing tendency of banks in many countries to avoid undue concentration in their loan portfolios and excessive growth of their balance sheets, may well give rise to complex and heretofore unresolved

dilemmas. How are these considerations to be reconciled with continued expansion of supplies reaching the Euromarket? With the balance-of-payments surpluses of OPEC countries rising rapidly, they can hardly avoid adding substantially to their outstandings in this market. In the third quarter of 1979, their aggregate placements with banks reporting to the BIS rose by about \$20 billion, and nearly all of it was deposited with banks outside the U.S. To this must be added sizable amounts of funds that escaped the BIS statistical dragnet. Meanwhile, the cashflows into the OPEC countries' coffers have increased substantially. Unless their investment strategy changes drastically, their offerings in international financial markets will rise by leaps and bounds in the foreseeable future. At the same time, international banks, both U.S. and European as well as Japanese, are likely to become more reluctant takers of money. Already their internal ratios of own funds to deposit liabilities and to total loans have reached uncomfortable levels in many cases. Increasing numbers of them do not wish to see their balance sheets ballooning to ever-increasing dimensions relative to their capital and reserves. Of course, they can lay off additional funds in the interbank market, but such placements provide only minimal profits and tend to reduce profits measured on the bank's equity. Still, it seems unlikely that additional funds offered in international banking markets will not find a home. In all likelihood, there will always be banks willing to add to their outstandings. However, the greater reluctance of some major banks to take on more funds may necessitate a further expansion of the list of banks acceptable to the monetary authorities in OPEC countries.

32. The prospective increases of available funds are unlikely to make major international banks more willing to provide ample additional credit to those developing countries that are very heavily indebted to them. There is evidence that during the last year or two, major U.S. banks have already slowed their international lending. It is also true, however, that a number of large regional banks have relatively small exposures to individual countries. Overall, in the United States, ratios of loans to developing countries to banks' capital or assets have declined slightly in recent years. Banks in other countries have taken up the slack and some banking groups in Europe have added heavily to their outstanding international loans. These banks have been interested in adding to their loans to developing countries even though the margins that could be earned on them in the late seventies were unattractive. A principal reason was that their relatively low capital to asset ratios allowed them to earn a higher return on capital for any given margin between their funding costs and the yield on their loans. Meanwhile, their loan to capital ratios have risen, but based on the latest information, these ratios still remain lower than in the United States. Nevertheless, indications of their increasing reluctance to step up their international lending to developing countries are multiplying. Moreover, the expansion in lending by European and Japanese banks has already caused some concern among their supervisory authorities.

33. At the same time, there has been some lessening of interest in syndicated loans among some international banks. One should always keep in mind that the syndicated medium-term loan market is only a part, and actually a relatively small part, of the Euromarket. By far the

greatest part of the market provides short-term self-liquidating credits to banks and corporations in many parts of the world. There is now a tendency among many international banks towards fostering trade-related credits that will give rise to a permanent bank relationship and larger correspondent balances. In the syndicated loan market, moreover, the major lenders are showing a preference for loans to governments and public and semi-public agencies in several semi-industrial countries, notably in Europe, whose borrowing requirements, as a result of their expanding balance-of-payments deficits, are rising fast. These various changes in lending directions are likely to be encouraged by supervisory authorities. Thus the market's further growth is unlikely to benefit those developing countries that have lately encountered resistance to their efforts to add to their borrowings. Further substantial accretions to Eurodollar supplies should by no means be viewed as an assurance that developing countries with uncertain economic or political prospects will always find additional suppliers among banks to satisfy their urgent borrowing needs. But the market's ongoing expansion should facilitate further borrowings by those developing countries that are viewed as prime risks and by semi-industrial countries with favourable monetary reserve positions and relatively low indebtedness.

34. Thus the conclusion suggests itself that though no dramatic measures to restrain the Euromarket's growth are about to be adopted by the governments and central banks of the industrial countries, their current preoccupation with the macro- and micro-economic implications of the rapid growth of international lending, together with the more conservative lending policies gaining strength in the international banking community, may well diminish developing country access to the Euromarket and thus pose grave problems for several of them.

35. One must also anticipate that at some stage the recent efforts to strengthen controls on the Euromarket will be resumed. This is foreshadowed by the above-mentioned section of the communiqué of the OECD central bank governors, in which they state that efforts will be continued to reduce differences in competitive conditions between domestic financial markets and the Euromarket. The U.S. representative at the central bank governors' meetings at the BIS will surely continue to press for the introduction of reserve requirements for Eurodeposits, in the expectation that central banks will show greater interest in the proposal if the Euromarket continues to grow much more rapidly than their domestic markets. Also efforts are likely to continue to achieve at least limited international agreements on uniform capital ratios to be applied to foreign loans in the hope that greater emphasis on capital adequacy will prevent excessive growth of international lending.

36. The market's lending potential will for some time be impaired by the repercussions of the blocking of all assets of the Iranian Government held in United States banks and their branches. This action has disturbed the cohesion of the market to some extent. Participation in syndicated credits is no longer diversified internationally to the same extent as previously. European banks tend to reduce the role of U.S. banks in management groups, and so-called club loans extended by closely-related banks are becoming more common.

37. The emerging trend towards greater discrimination as to borrowers is already affecting terms and conditions of loans. There is already much evidence of a widening in interest differentials between various groups of borrowers. Prime credit risks in the OECD countries are continuing to be able to borrow at very favourable terms both as to spreads and maturities, but borrowers in developing countries are experiencing a noticeable hardening of loan conditions.

38. Early in 1980 the pace of syndicated lending slowed perceptibly, but this slackening is unlikely to be more than a temporary phenomenon. The market was, of course, substantially affected by the severe credit restraint measures in the United States adopted within the framework of President Carter's anti-inflation programme in March, and by the repercussions of this programme in the financial markets of other industrial countries. In Japan, moreover, the deteriorating balance-of-payments situation caused the monetary authorities to severely restrict their banks' international lending activities, exceptions being made only for project financing of immediate interest to the authorities. The recent easing of monetary restraint in the U.S. and the plummeting of interest rates in the Eurodollar market has changed the market climate significantly. Moreover, as the yen rate in dollar terms rose sharply, the Japanese authorities, in the spring of 1980, again liberalized international lending by Japanese banks. As the present restrictive monetary policies in the industrial countries of Western Europe are reversed in response to cyclical downturns and the widely expected decline in domestic loan demand, international banks operating in the market may become increasingly interested in finding additional outlets for their surplus funds and become more responsive to borrowing countries' requests for additional loans.

39. In the longer run, the Eurocurrency market's growth regardless of the current efforts to restrain its expansion is bound to remain large in percentage terms. It will respond to the ever-increasing requirements for the financing of world trade and other international transactions. Aggregate current account imbalances are likely to remain large in the years ahead and in their financing the Euromarket will do its part. The supply of funds will continue to be augmented not only by official and private entities in the surplus countries, but also by continued injections of central bank money into the world's banking system so as to foster economic activity and high levels of employment. The cautionary policies which may emerge from the decisions of the OECD governors and more conservative lending policies of the major banks themselves will not prevent the satisfaction of the borrowing requirements of those countries which meet more stringent standards with respect to risk. However, where these more stringent standards cannot be met, reliance on borrowing from official bilateral and multilateral sources will tend to increase accordingly.

Appendix

Communiqué of Group of 10
Basle, 14 April, 1980

1. At their meetings in Basle on 10 March and 14 April, the central bank Governors of the Group of 10 countries and Switzerland exchanged views on the evolution during recent years, and the future prospects, of the international banking system in general, and the Eurocurrency market in particular.
2. The Governors recognize the important part played by the banks in recycling large surpluses which have arisen during the last few years. They noted that international bank lending aggregates have been expanding at an annual rate of some 25 per cent. Moreover, the contribution of the international banking system to recycling the large OPEC (Organization of Petroleum Exporting Countries) surpluses that have re-emerged will lead to further substantial growth of these aggregates.
3. In view of the present volume of international bank lending and of its prospective future role, the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects, either worldwide or on the conduct of policy in particular countries.
4. With these considerations in mind, the Governors have decided to strengthen regular and systematic monitoring of international banking developments, with a view to assessing their significance for the world economy, for the economies of individual countries, including particularly the operation of their domestic monetary policies, and for the soundness of the international banking system as a whole. A Standing Committee on Euromarkets will consider the international banking statistics compiled by the BIS and other relevant information and report to the Governors at least twice a year, and more frequently if developments call for it. These arrangements for closer surveillance could provide a framework for intensifying, if appropriate, co-operation on monetary policies between the countries concerned.
5. Recognizing that individual banks, or the international banking system as a whole, could in future be exposed to greater risks than in the past, the Governors reaffirm the cardinal importance which they attach to the maintenance of sound banking standards - particularly with regard to capital adequacy, liquidity, and concentration of risks. To this end they place high priority on bringing into full effect the initiatives already taken by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

6. The Governors note that differences in competitive conditions between domestic and international banking that arise out of official regulations and policies stimulate growth of international bank lending in general; and that transactions channelled through the Eurocurrency market can pose problems for the effectiveness of domestic monetary policy in those countries where such differences are particularly significant. The Governors will continue efforts already being made to reduce the differences of competitive conditions, fully recognizing the difficulties arising from differences in the national structure and traditions of banking systems.

IMPLICATIONS OF THE EUROPEAN MONETARY SYSTEM FOR DEVELOPING NATIONS

Benjamin J. Cohen*

1. On 13 March 1979, the European Community launched a new initiative in regional monetary organization - the European Monetary System (EMS). The purpose of this paper is to examine the principal implications of EMS for developing countries. The conclusions of the paper are generally cautious. Despite evident attractions, EMS does pose risks for developing countries. And while it would be inappropriate to be alarmist, it would be prudent to be wary. Any more sanguine attitude, I believe, would be unrealistic.

2. The organization of the paper is as follows. Section I outlines the principal features of EMS, its performance to date, and prospects for the future. Potential implications for developing nations are considered in the next three sections. Section II focuses on the exchange-rate arrangement of EMS; Section III, on liquidity and financing provisions; and Section IV, on institutional aspects. The paper concludes with a brief summary of conclusions in Section V.

I. PRINCIPAL FEATURES, PERFORMANCE AND PROSPECTS

3. The first direct impetus for the European Monetary System came from Roy Jenkins, President of the European Commission, who in his Jean Monet Lecture in October 1977 (as well as in subsequent private lobbying efforts with member-governments) attempted to kindle interest in a new Community monetary initiative. 1/ Six months later these efforts appeared to bear fruit, when Germany's Chancellor Helmut Schmidt unexpectedly put forth a radical new plan of his own for creation of a "zone of monetary stability" in Europe. First unveiled at a meeting of the European Council (the Community summit) in Copenhagen in April 1978, the idea of EMS was formally endorsed at a second Council meeting in Bremen in July and, after protracted negotiations, agreed in detail at a third summit in Brussels in December. 2/ Launching initially was set for the new year but then was delayed for two and a half months until a Franco-German dispute over the Community's common farm policy could be satisfactorily resolved.

A. Principal Features

4. EMS consists of three interrelated elements, each building on already existing Community structures: (1) an arrangement for linking

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exchange rates; (2) a projected European Monetary Fund; and (3) a system of credit facilities for mutual payments support.

(1) The exchange-rate arrangement

5. The arrangement for linking exchange rates builds on the old "snake" - the scheme for narrowing margins of fluctuations between member-currencies that first took life seven years earlier, in April 1972. Originally, the snake had been meant to encompass all nine Community currencies. But owing to a variety of problems, within two years of its birth, five of the Community's members - Britain, Denmark, France, Ireland and Italy - had been forced to withdraw (though Denmark later rejoined, while France tried and failed). By 1976, the joint float had been reduced to just five Community members (the three Benelux countries, Denmark and the Federal Republic of Germany) plus two outsiders (Norway and Sweden) and two informal "associates" (Austria and Switzerland). And by 1978, when the negotiations for EMS were begun, even one of the outsiders (Sweden) had left.

6. In effect, what the new arrangement aims to do is reabsorb non-participating member currencies within the narrow margins of fluctuations (+2.25 per cent around central rates) set by the continuing float of the five Community snake countries. (The last outsider, Norway, dropped out in December 1978.) At the Brussels summit, the French Government committed itself to immediate re-entry into the snake. After some hesitation, so too did Ireland and Italy, although in Italy's case initially only within a broader band of movements of up to six per cent in either direction. Britain, on the other hand, refused to commit itself at all, arguing that its payments position was still too precarious to join in. For the time being the pound sterling continues to float independently, as it has since 1972.

7. In designing this new "supersnake", the biggest question was what operational rules should apply to govern central-bank intervention to maintain the joint float. Two alternative mechanisms were considered. One mechanism - the "parity grid" solution - would simply have continued to tie each currency to each other currency in a matrix of bilateral cross-rates, as in the old snake. The other - the "basket" solution - would have worked by tying each currency instead to a European unit of account, renamed the European Currency Unit (ECU), equal to a weighted average of all the currencies together. (It is no accident that the acronym ECU also happens to be the name of an ancient French silver coin.) Much heat was generated in choosing between the two mechanisms, since each implied very different intervention obligations under varying circumstances. For example, should one country's currency - say, the Deutschmark - have begun to move sharply out of line, only that country's central bank would have had responsibility to intervene if the basket solution alone were in effect; all central banks would have been obliged to intervene with the parity grid. Not surprisingly, therefore, given the anticipated strength of the Deutschmark, weaker countries like Italy and Britain argued for the basket approach alone. But owing to the opposition of the Federal Republic of Germany, that solution was ultimately rejected in favour of using the parity grid as the primary guide to intervention obligations. As a concession to the weaker

countries, however, it was agreed that the ECU would nevertheless be retained (a) to define the central rates of the parity grid - in effect, to function as denominator (numéraire) for the exchange arrangement; and (b) to be used as a "divergence indicator" - that is, as a sort of alarm bell or early warning signal to indicate when any single country's currency might begin to diverge too far from the weighted average. In principle, this would create a "presumption" for that country to act, either in the exchange market or by adjusting domestic monetary and fiscal policies. ^{3/} At the outset, the value and composition of the ECU were set equal to those of the formal European Unit of Account that had been introduced in April 1975 for transactions under the Lomé Convention (Table 1).

(2) The European Monetary Fund

8. The projected European Monetary Fund (EMF) is intended to build on the so-called European Monetary Cooperation Fund (known as FECOM by its French initials), first established in April 1973 as part of the Community's earlier snake initiative. Originally intended as an embryonic European central bank FECOM was supposed to supervise all Community credit facilities related to exchange rates and balance-of-payments financing. In fact, however, it has never existed in anything but name, having neither a headquarters nor a staff. (The settling of debts among the snake's central banks has actually always been done by the Bank for International Settlements in Basle, and all decisions have simply been taken by the Community's committee of central-bank governors wearing their hats as the board of FECOM.) EMS aims to breathe life into FECOM, renamed EMF, by pooling under its authority a portion of the gold and dollar reserves of all Community members, in exchange for which members receive deposits in the EMF, denominated in ECU, to be used in settlement of intra-Community debts (of all kinds). In effect, the ECU is thus intended to become not just the numéraire and divergence indicator of the exchange-rate arrangement, but also a full-fledged means of intra-central bank settlement similar to the IMF's Special Drawing Right, although for the present at least for use only within the European Community itself. Significantly, ECU are available to all members of the Community - even Britain - since access to the Fund is not limited to snake participants alone. However, to avoid any question of transfer of ownership in the absence of requisite national legislation, reserve pooling initially has been carried out simply in the form revolving three-month "swaps" among the separate monetary authorities. For the present, 20 per cent of all gold and dollar reserves have been informally pooled in this manner. At the Brussels summit, the European Council declared its intention to bring the EMF into full formal existence in a second stage "not later than two years after the start of the scheme", ^{4/} i.e., not later than March 1981.

(3) Credit facilities

9. Although eventually all Community credit facilities are supposed to be consolidated under the aegis of the EMF, for the time being the issue of credit is kept quite separate. Presently, the EMF is simply a mechanism for swapping existing reserves for ECU. Credit continues, as in the past, to take the form of loans made directly between member-countries, including: (a) Very short-term borrowings, which have to be repaid within 45 days (and are available only to snake

participants); (b) Short-term monetary support, which must be repaid within nine months; and (c) Medium-term financial assistance, comprising loans up to five years in length. Very short-term borrowings have always been available in unlimited amount. The EMS agreement called for increasing "effectively available credit" under the short-term facility from the equivalent of 5.5 billion to 14 billion ECU (approximately \$18 billion) and under the medium-term facility from the equivalent of 4.5 billion to 11 billion ECU (approximately \$14 billion). These credit increases amounted, in effect, to a substantial concession by the Federal Republic of Germany, potentially the largest creditor in the Community, to weaker members such as the United Kingdom, Ireland and Italy.

(4) Additional financial concessions

10. The Federal Republic of Germany also backed additional financial concessions to weaker members (quite apart from expansion of the short-term and medium-term credit facilities) in the form of supplementary subsidized loans from the European Investment Bank and other Community institutions. The weak countries regarded such "transfers of resources" as essential if they were to be able to withstand successfully the potentially harsh disciplines of a joint float. Indeed, Ireland and Italy all along had made clear that increased transfers were an absolute condition for their agreement to re-enter the snake, and their hesitations were not in fact overcome until the promise of additional financial concessions was assured. ^{5/} British hesitations, on the other hand, as already indicated, have not yet been overcome.

B. Performance

11. To date, EMS has operated without undue strain, confounding skeptics who had predicted a rather swift collapse. ^{6/} Fluctuations of exchange rates of participating currencies in 1979 were the most moderate recorded in eight years (Table 2); for all Community currencies taken together, the annual average fluctuation against the ECU, at 1.9 per cent (down from 2.7 per cent in 1978), was the lowest since 1972 (1.2 per cent). ^{7/} And these trends have continued in 1980 as well. So far, at least, EMS does not seem to have betrayed its goal of creating a "zone of monetary stability" in Europe.

12. Not that the system has been entirely without strain. In fact, tensions involving several members developed fairly quickly in the spring and summer of 1979, following a decision of the Bundesbank at the end of March to tighten monetary policy sharply in an effort to reverse an accelerating domestic inflation rate. Capital began to flow into the Federal Republic of Germany on a large scale, despite competing increases of interest rates elsewhere in the Community (Table 3); and by early June both the Belgian franc and the Danish krone had been driven to the floor of the parity grid, well past their ECU divergence limits. Yet in June and July the Federal Republic of Germany continued to tighten monetary policy, despite some complaints from the weaker members. In the view of the Federal Republic of Germany, primary responsibility for adjustment lay with Belgium and Denmark, whose currencies were below their divergence limits. In the view of Belgium

and Denmark, however, it was the Federal Republic of Germany which should have been acting, by relaxing monetary policy. That the Deutschmark had not exceeded its divergence limit was merely a statistical fluke, owing to a concurrent rise of the pound sterling and Italian lire that was making the mark look artificially weak. 8/ The Federal Republic of Germany, it was argued, was giving priority to their fight against inflation, even at the expense of their partners in EMS. 9/ But in the end both sides found ample grounds for compromise and mutual accommodation, and the tensions were removed by a moderate realignment of EMS central rates in September, with the Deutschmark being revalued by 2 per cent and the Danish krone devalued by 3 per cent against the other participating currencies (Table 4). Since that date, little stress has been experienced in the arrangement (despite a second devaluation of the Danish krone by 4.76 per cent in late November). 10/

13. Exchange-market interventions by participating central banks were fairly substantial only in the first few months after EMS was launched; and even of these, most were for the purpose of influencing movements vis-à-vis the U.S. dollar rather than to relieve strains within the joint float. Borrowings under the very short-term credit facility have been relatively modest (the maximum being reached in August 1979 - just prior to the September realignment - with borrowings of about one billion ECU). No calls at all have been made on either the short-term or medium-term facilities. 11/

C. Prospects

14. What are the longer-term prospects for EMS? Its relative calm until now might be thought to imply a probability of smooth sailing in the future too. And indeed, many observers have perceived real grounds for optimism on this score. 12/ But, equally, other sources have been more skeptical regarding the long-term viability of EMS. 13/ The Community's initiative has been widely evaluated and analyzed. 14/ Most commentaries, whether by proponents of EMS or by skeptics, agree that two questions in particular will be pivotal in determining the system's future. These are the questions of (1) convergence of economic policy and performance among participating countries; and (2) development of a joint policy vis-à-vis the currencies of non-participating countries (especially the dollar).

(1) The convergence issue

15. Some degree of convergence of economic policy and performance among the participating countries is manifestly essential to the system's long-term viability. In the words of one of its principal architects:

To be successful, the EMS, first of all, will have to be accompanied by policies designed to achieve a greater convergence of the economies of member-states. The EMS cannot be durable and effective unless it is backed by complementary policies... Great effort on the part of all countries and in all areas of policy will be needed if the system is to last. 15/

16. The dilemma is clear. Convergence requires a genuine political

commitment on the part of all participants to surrender a portion of their traditional policy autonomy. This is not easy to attain. Yet if it is not attained, the system is bound to come under strain sooner or later. Persistent differentials of inflation rates and other factors affecting mutual payments positions would inevitably set in motion strong centrifugal forces to pull the joint float apart. Participating governments would then be faced with the Hobson's choice of either altering their exchange rates frequently in order to avoid speculative build-ups, or else defending their linked rates futilely with prolonged and costly intervention. Either course could make a mockery of their avowed goal of a "zone of monetary stability".

17. Significantly, to date, no real signs of converging performance can be found. Quite the contrary, inflation rates within the Community remain highly divergent - indeed, even more divergent now than when EMS was first launched. According to IMF data, in the first quarter of 1979 the maximum inflation differential among participating countries was 9.9 percentage points; a year later, it was 15.4 - that is, 50 per cent greater (Table 5). And this trend is confirmed by EC data as well, which shows a steady increase of divergence of price performance throughout 1979 (Table 6). According to projections by the European Commission, the trend can be expected to persist through the remainder of 1980 (Table 7).

18. In view of these widening divergencies, it is instructive to ask how nonetheless EMS could have operated until now with so little apparent strain. Four factors, in particular, seem to stand out - (a) The fact that when the system was first launched, central rates had in effect already been adjusted to discount for a certain amount of divergence of inflation rates in the near term; (b) The willingness of participating governments, since launching, to make active use of interest rates to keep exchange values from moving too far apart; (c) The influence of differential real economic growth rates and demand management policies in the participating countries, which have helped to maintain the balance-of-payments strength of some of the highest-inflation countries (e.g. France and Italy, both of which ran large and steady current surpluses in 1978-79) while contributing to the deterioration of the external position of some of the more price-stable members (especially the Federal Republic of Germany, whose current balance swung from a substantial surplus in 1978 to sizable deficit last year); and (d) The relative stability of the dollar (see below, paras. 23-24). The essential question is how long can these factors be expected to continue to prevail over the cumulative impact of persistent price divergences? As the Bank for International Settlements commented in its latest Annual Report, "The longer-term success of the system will certainly depend on a reduction of these divergences." 16/

19. Consider the experience of the Community's earlier snake (para. 5), which did not succeed - at least, not in the sense of holding together all of the original participants in their joint float (at a time when inflation rates in Europe were actually less divergent than they are now). According to a special study group (the Marjolin Committee) appointed by the Community to study the experience, the snake failed for

three principal reasons: "unfavourable events, a lack of political will, and insufficient understanding". 17/ The "unfavourable events" included inflation and the energy crisis; the "insufficient understanding" referred to a total lack of prior analysis, at either the national or the Community level, of the conditions necessary for making a common currency operational. But clearly the most critical of these three reasons was the "lack of political will". At a lower level, national administrative hierarchies resisted all encroachments on their bureaucratic power and privileges; central bankers, in particular, were unwilling to become submerged in a kind of European Federal Reserve System. And at a higher level, national political leaderships resisted all encroachments on their traditional decision-making authority: governments were unwilling to transfer any significant portion of their formal sovereignty to Community institutions. As the late Fred Hirsch wrote in 1972:

In this sense one can conclude that European monetary integration is not a serious issue. It belongs to that category of commitments that are endorsed by national authorities at the highest level, but are in fact ranked low in their priorities when it comes to the test. 18/

20. The essential question, rephrased, therefore is whether the participants this time round are truly prepared to make EMS a "serious issue"? Do they now truly intend to rank it high among their policy priorities? According to EMS proponents, the answer is most definitely in the affirmative, as witness, e.g., the comparative ease with which the two exchange-rate realignments last year were carried out. In their view, at the economic level two main differences distinguish EMS from its predecessor - (a) decreased rigidity of mutual exchange rates (reflecting an increased readiness on the part of all participants to move quickly to make small rate adjustments whenever it seems necessary); and (b) increased symmetry in the distribution of adjustment obligations (reflecting the effect of the ECU divergence indicator, which is supposed to ensure that adjustment pressures are felt by surplus as well as by deficit countries). Above all, they argue, there is a political difference. Unlike its predecessor, EMS is indeed backed by the necessary political commitment. The "political will" is there - in particular, in the two major members, France and the Federal Republic of Germany; and most specifically, in the persons of President Valéry Giscard d'Estaing and Chancellor Schmidt, for whom EMS has in effect become a test of their joint de facto leadership of the Community. Interesting evidence of this, according to sources in Europe, 19/ is to be found in a softening of resistance by central bankers in the European Community (who now apparently feel that given the strength of the commitment to EMS at the political level, their powers and privileges are more likely to be preserved by supporting and influencing the design of the system than by opposing it).

21. Skeptics, however, remain less than wholly convinced. At the moment, national economic authorities still have no formal limitations on their policy autonomy. As one source has commented: "As in the past the great drawback is the absence of binding commitments..." 20/ Under the ECU divergence indicator, for example, as already indicated (para.7)

the alarm bell is meant to signal only a "presumption" of action, not a legal obligation; and even with respect to that presumption, no formal definition has ever been agreed as to the precise nature of the action (or order of priority among alternative actions) that might be expected. As the experience in the spring and summer of 1979 demonstrated, the resulting ambiguity can in fact lead to controversy and acrimony (para. 12). No one really knows what would happen if worse strains were to develop in the future. The one thing all observers agree is that the system has yet to be seriously tested. In effect, the jury is still out on this issue.

(2) The dollar issue

22. The other essential for the long-term viability of EMS is development of a joint policy vis-à-vis non-participating currencies - in particular, vis-à-vis the dollar. "An absolute condition of success" is the way one key Community figure describes it. 21/ The reason is clear. So long as the dollar remains generally stable, the system need only be concerned with managing its own parity grid. But should the dollar come under pressure, severe strains could be generated in intra-EMS exchange relations as well (in part, precisely because of the continuing lack of convergence of economic performance in the Community); and this, in turn, could lead to conflicts of policy among the members. Governments might well disagree on the direction in which to "manage" their joint float against the dollar. Uncoordinated dollar interventions would obviously add to volatility in exchange markets, once again making a mockery of the system's avowed goal of a "zone of monetary stability".

23. In fact, it was precisely the instability of the dollar in 1977-78 that set the stage for EMS in the first place. The prolonged depreciation of the dollar wreaked havoc in European financial markets. Since dollar holders anxious to diversify or hedge their portfolios were, not surprisingly, attracted to strong currencies like the Deutschmark or Dutch guilder (or Swiss franc or Japanese yen), rather than to such moneys as the Italian lire or French franc, dollar sales inevitably meant additional upward pressure on the stronger EC currencies relative to the weaker ones, accentuating monetary fragmentation within the Community. For Chancellor Schmidt, one of the original motivations of his proposal for a European "zone of monetary stability" was his desire to slow down the appreciation of the Deutschmark, which was threatening to hurt German exports. A principal attraction of EMS for other Community members was that it would help shield them from similar instabilities of the dollar in the future.

24. Happily, since the launching of EMS, the dollar has been relatively stable, making a contribution to the smooth performance of EMS to date (para. 18). But no one knows for how long this fortuitous circumstance may continue. The possibility of renewed pressures on the dollar cannot be excluded - and neither, therefore, can the need for a common dollar policy. In principle, participating countries are committed by the original EMS agreement to "coordination of exchange rate policies vis-à-vis third countries". 22/ In practice, not even a start toward an explicit dollar policy can so far be detected; and this clearly poses

risks for the successful operation of EMS in the future. The issue, as one observer has rightly insisted, "cannot be fudged for very long". 23/ In the words of one dispassionate study:

It is a potentially serious flaw of the EMS that no clear guidelines on such a common policy have yet been established ... This flaw need not be fatal ... But it raises the spectre of a continual conflict of interest among the members. 24/

D. Next Steps

25. Whatever the longer-term prospects for EMS, in the near term members seem determined to keep forging ahead - though not, it appears, in time for the March 1981 deadline originally set for the project's second stage (para. 8). Unlike stage one, stage two would almost certainly require formal legislation at the national as well as Community level (paras. 26-28 below). But neither of the system's prime movers, President Giscard d'Estaing nor Chancellor Schmidt, appears anxious to risk new domestic political controversies prior to their respective national elections (scheduled for October in the Federal Republic of Germany and for April 1981 in France). According to sources in Europe, once these elections are past, new steps can surely be expected. But for the time being at least, the precise shape of those steps cannot confidently be predicted. Technical studies meanwhile continue, both at the European Commission and in national governments, focusing on three specific issues: (a) construction of the EMF; (b) further development of the ECU; and (c) management of the Community's credit facilities.

(a) The EMF

26. The deadline for stage two was established originally by the European Council's pledge at the Brussels summit to transform FECOM into a full-fledged European Monetary Fund "not later than two years after the start of the scheme". This pledge (if not the deadline) still remains operational, according to European sources. The problem is to define the EMF's formal mandate and authority. Should the EMF be designed as an embryonic European central bank, to grow as it were "from within", by gradually taking over functions and responsibilities presently exercised by national central banks? Or should it instead operate "from without", rather as the International Monetary Fund does, imposing its will on national monetary authorities only in certain specified circumstances, i.e., in the event of external imbalance (but otherwise leaving the functions and responsibilities of national central banks more or less intact)? And who would actually manage the EMF - national central bank governors? an independent board? finance ministers? These are obviously deeply political questions involving real issues of national monetary and economic sovereignty. They are unlikely to be resolved by purely technical studies.

(b) The ECU

27. In the original EMS agreement, stage two was also supposed to witness the beginning of "full utilization of the ECU as a reserve asset and a means of settlement". 25/ But this too obviously involves deeply political questions. Should ECU be created only through the pooling of

gold and dollar reserves, as at present, or should they be formally created against transfers of national currencies as well (thus adding, on a net basis, to the stock of official liquidity)? Would intra-EMS settlements in ECU be obligatory or voluntary? Could ECU be converted into other reserve assets at will? Would ECU be available to non-official transactors within the Community? Would they be available to non-Community transactors? These too are not simply technical questions.

(c) The credit facilities

28. Finally, consideration is currently being given to the possibility of further expanding or consolidating the Community's three existing credit facilities. At present, the very short-term and short-term facilities both are the province of central banks. (Indeed, the very short-term facility is best understood less as a true credit mechanism than as a compulsory financing arrangement that is the logical counterpart of central bank intervention obligations in the joint float.) The medium-term facility, by contrast, is operated by finance ministers and is less a matter of monetary than of fiscal policy. One possibility for the future might be to consolidate all three facilities under a single authority, perhaps the EMF; another might be to provide for creation of ECU not only through formal reserve or currency pooling but through activation of the credit facilities as well. Since these possibilities clearly hinge on the decisions to be taken about the future of the EMF and ECU, ultimately they too will be resolved only at the political level.

II. EXCHANGE RATES

29. Although developing nations are not direct participants in EMS, indirectly their interests may well be influenced by the scheme's present structure or future development. Three aspects of EMS stand out in this connexion: (1) the exchange-rate arrangement; (2) liquidity and financing provisions; and (3) institutional aspects. The first of these three is examined in the present section, the second and third in the two sections to follow.

30. Few things would benefit developing nations more than if EMS were truly to succeed in creating a "zone of monetary stability" in Europe. Since the move to floating rates among the major currencies occurred back in 1973, developing countries have complained bitterly - and not without justification - about the problems that have been caused for them. Their predicament has been summarized admirably by the IMF:

The short-run fluctuations in exchange rates in recent years have also caused problems for the less developed countries, despite the fact that most of them continue to peg their exchange rates. For those countries that peg to a single currency - and most of the less developed countries are in this category - greater exchange rate variability between the intervention currency and other currencies is likely to result in an increase in variability in both the country's effective exchange rate and in the local

currency price of its imports and exports. Increased short-run fluctuations among the major currencies also may mean that a less developed country's exchange rate (vis-à-vis countries with which it does an important part of its trade) responds to factors more closely associated with the external position of the country issuing its intervention currency than to its own domestic or balance-of-payments needs. Some less developed countries have attempted to minimize these problems by switching from a unitary peg to a peg based on a basket of currencies, but many countries find this solution administratively inconvenient, particularly when there is a single dominant currency used in trade and exchange transactions...

The increase in exchange rate fluctuations has also caused problems of portfolio management for the less developed countries, most of which hold nearly all of their foreign exchange reserves in a single currency. While the fluctuations in exchange rates have diminished the store-of-value function of some of the major currencies, the rise and variability in import costs have led to a demand for higher and more assured levels of reserves. Those less developed countries that peg to a single currency whose future value is uncertain may therefore face the dilemma that they need to hold larger working balances in that currency, yet they may also wish to diversify their reserves. 26/

While a "zone of monetary stability" in Europe would hardly eliminate all these problems, the chances are that it would help to alleviate many of them, insofar as short-run fluctuations in a key group of major currencies are in fact reduced. A successful EMS would have the direct effect of rendering developing countries' exchange rates less susceptible to arbitrary influences beyond their control, as well as broadening the range of options effectively available to such countries for pegging their currency values or managing their reserve portfolios.

31. A successful EMS would also benefit developing nations indirectly insofar as - through its potentially positive impact on economic activity in the European Community and financial conditions - it helps to improve developing countries' export sales or their access to credit markets. Community countries are among the most important trading partners and sources of finance of a large number of developing nations. Successful reduction of monetary uncertainty in Europe would be likely not only to improve the climate for investment and growth in the Community (of particular importance to developing countries' export prospects), but also to lead to a more open and receptive environment in Community credit markets (of particular importance to developing countries' borrowing prospects). Indeed, the more successful EMS is in this regard, the more likely it is to lead to a relaxation of monetary restraints and/or capital controls affecting the Euromarkets as well, thus increasing developing countries' access to private lending in international as well as national credit markets.

32. Unfortunately, as already indicated (paras. 14-24), it is by no means certain that EMS will in fact succeed in creating a true "zone of monetary stability". The sine qua non for a successful EMS (and hence

for an outcome favourable to developing countries) is that the members learn to deal adequately with the convergence and dollar-policy issues. If they do not, the denouement of their initiative could actually be quite different. Two dangers pose themselves - (a) that overall exchange instability might be increased rather than decreased; and (b) that a deflationary bias might be introduced into the economic policy and performance of the countries of the European Community. Either outcome would be detrimental to the interests of developing nations, by raising the threat of commercial and/or capital controls that could jeopardize their access to key export and/or credit markets.

A. Exchange Instability

33. Given the inability of EMS partners to date either to achieve real economic convergence or to develop an explicit dollar policy, scenarios leading to increased exchange instability (as compared with present EMS performance) are not difficult to conceive. 27/ Whether one starts with renewed pressure on the dollar in exchange markets, or with the cumulative impact of persistent inflation differentials on mutual payments positions, the outcome is potentially the same: strains would develop in the joint float, policy conflicts would erupt, and the system would be subjected to periodic speculative crises rather in the manner of the old Bretton Woods pegged-rate system. As compared with a regime of more freely floating exchange rates, it is by no means certain that such a system, in which central banks might be constantly under pressure to outguess or outgun speculators, would represent any significant improvement. Arguably, average instability worldwide might even turn out to be worse, e.g., if overall speculation is increased as a result of the "one-way option" offered by pegging within the joint float; or if efforts to maintain the joint float increase the volatility of fluctuations between participating and non-participating currencies.

34. But are such scenarios realistic? The danger, at least in hypothetical terms, is conceded even by EMS proponents. 28/ But it is not a danger that, in practical terms, is regarded as likely to be very serious, mainly for reasons already outlined above (para. 20). Given the strength of the existing political commitment to EMS, proponents contend, the absence of binding policy obligations on governments is hardly critical. The "will" is there - and that is what really matters. A genuine change of attitude has occurred, it is argued, especially in the system's more inflation-prone members where, as one source describes it, "past attitudes to the role of exchange-rate changes as an instrument or as an escape route to reach a more satisfactory combination of balance on current external account and higher levels of employment and investment [have] been increasingly questioned." 29/ Today, governments appear to be fully persuaded of the need to make domestic stabilization policies their first line of defence when payments difficulties are encountered.

35. In any event, according to proponents, the joint float incorporates sufficient elements of flexibility to successfully accommodate any residual exchange-market pressures that may nevertheless develop. For individual members like Italy (or others in a similar position, should they so choose), wider margins around central rates are permitted. 30/

And for members generally, changes of the central rates themselves are still a recognized option, should a currency's ECU divergence limit be exceeded. 31/ European sources stress that theirs is by no means a rigid lock-step arrangement. Quite the contrary, the aim of the joint float is to manage exchange rates in an orderly fashion - not to defend them to the death. Reflecting lessons learned from the experience of the old snake, governments today are evidently ready to yield quite quickly to exchange-market pressures when it seems necessary (as in last year's two realignments), rather than to oppose them with prolonged interventions (para. 20). In the words of one well-placed observer:

Over the last two-and-a-half years of the snake five small adjustments were made and the system was beginning to look more like joint management of a crawling peg system than like a rigid mini-Bretton Woods system. The practice was continued in the EMS... There is obviously an understanding that exchange-rate changes must be kept small and relatively infrequent for the EMS to avoid the kind of massive speculative capital flows which made the Bretton Woods system unviable. 32/

Quick and small adjustment of central rates also offer the technical advantage of allowing continuity of market rates, thus cancelling any sure gain to speculators from the "one-way option" when formal realignments are enacted. This too helps reduce the danger of exchange instability.

36. Indeed, if the arguments of EMS proponents are to be fully believed, this is not a danger worth worrying about at all. But that is perhaps too sanguine a conclusion. More realistically, even while conceding the force of the observations just outlined, one must recognize that, at bottom, their optimism is based more on faith than hard evidence. In the absence of binding legal obligations (or, sometimes, even in their presence), governments feel free to change their minds - and their policies. Developing nations would be ingenuous to assume otherwise. While the risk of increased overall exchange instability would not appear to be high, it is surely greater than zero. Even the most optimistic of EMS proponents warn against undue complacency in this regard. 33/

37. Ultimately, as the saying goes, the proof of the pudding is in the eating. In EMS, the proof will be in the extent to which - and the speed with which - participants can make progress in reducing elements of ambiguity in their exchange-rate arrangement. Can they clarify just what obligations are "presumed" when a currency's ECU divergence limit is exceeded? Can they make a start towards a more formal convergence of domestic monetary and fiscal policies? If they can, then the optimism of EMS proponents may turn out to be warranted. But if they cannot, developing nations would be wise not to bank on continued monetary stability in the European zone.

B. Deflationary Bias

38. The alternative danger of the EMS exchange arrangement is that it could introduce a deflationary bias into EC policy and performance. In

effect, this is the "flip side" of the convergence issue. By definition, if inflation differentials are to be narrowed, either the high-inflation countries (e.g., France, Italy) must inflate less or the price-stable members (in particular, the Federal Republic of Germany) must inflate more. But no one in Europe wants to raise the Community's average of inflation rates; and in any event, no one expects that the Federal Republic of Germany, with its long history of aversion to rising prices, would even consider the possibility of deliberately accelerating its own national rate. Quite the contrary, all evidence suggests that, as in the spring and summer of 1979 (para. 12), the Federal Republic of Germany will continue to give priority to their domestic anti-inflation fight, even if this should add to the external pressures on some of their EMS partners. In practice, therefore, convergence is likely to mean alignment downward towards the Federal Republic's relatively low inflation rate (as it did in the old snake); and this in turn implies the possibility of a deflationary bias in the system that could undermine real growth and employment in the Community.

39. While also conceded by EMS proponents, this danger too is regarded as unlikely to be serious in practical terms ^{34/} - and in this instance at least, such optimism seems justified. In reality, if there is any bias in the system at all, it is more probably in the opposite direction (see below, paras. 49-51). Experience to date has not revealed a single instance of truly severe deflationary policies in any of the participating countries. (Ironically, the most ruthless deflationary policy in the Community today is to be found in Britain, the one member that has remained outside the joint float; while, in the meantime, the Federal Republic's inflation rate - policy intentions to the contrary notwithstanding - has actually drifted upwards since EMS was launched.) Furthermore, if serious pressures were to develop, recourse could be had either to the system's expanded credit facilities (in the cases of Ireland and Italy, to the system's additional financial concessions as well) or to the other elements of flexibility in the EMS design (para. 35). The joint float is by no means a strait-jacket on its members.

40. In any event, insofar as any deflationary bias might tend to develop in the Community, it would be because of a general policy commitment to price stability rather than as a result of any specific commitment to EMS. EMS should not be blamed for what governments may be inclined to do anyway. In fact, the exchange-rate arrangement is seen as a potentially useful tool in this regard - particularly by the smaller Community members who, from their experience in the old snake, have learned the advantages of the option of pegging their rates to an external currency facing less rapid inflationary prospects than prices and costs at home (the so-called "strong-currency option"). ^{35/} The potential for price discipline is also one of the system's attractions to President Giscard d'Estaing, since it complements and reinforces his present domestic commitment to firm anti-inflation policies. In this sense, EMS is not the problem at all - but, rather, is regarded as part of the solution.

41. Of course, initially some transitional difficulties could be encountered by some countries in submitting to the rigors of the "strong-

currency option". (Insofar as one of these countries may be France, this would imply some transitional difficulties as well for the fourteen African nations linked to France in the Franc Zone, e.g., higher borrowing costs in France if French interest rates must be raised in order to keep the French franc in the joint float.) But beyond the near term, any such disadvantages would probably be more than matched by the advantages of diminished pressure to adjust domestic policies continually in order to maintain external balance. In the longer term - members would actually gain rather than lose room for manoeuvre in their pursuit of higher growth and employment. Developing nations need not worry about any deflationary bias in EMS as a secular tendency.

III. LIQUIDITY AND FINANCING

42. The liquidity and financing provisions of EMS pose three dangers of particular importance to developing nations: (a) They could add to the problem of destabilizing international capital movements and portfolio shifts; (b) they could introduce an inflationary bias into the economic policy and performance of the countries of the European Community; and (c) they could erode the status of the Special Drawing Right and jeopardize future SDR allocations. All would be detrimental to developing countries' interests.

A. Capital Movements

43. Developing nations are clearly affected by destabilizing capital movements and portfolio shifts, which have been a primary cause of the troubling increase of exchange-rate volatility in recent years. Central to this problem (the so-called "confidence problem") is the issue of the dollar, whose historical pre-eminence both as reserve asset for central banks and as vehicle currency for private transactions has increasingly been called into question. Indeed, since the move to floating exchange rates among the major currencies back in 1973, an apparently secular trend towards diversification out of the dollar has developed, and this in turn has added considerably to developing countries' difficulties of portfolio management (para. 30). One danger of EMS is that it could exacerbate the confidence problem by broadening the range of attractive alternative assets available to dollar holders anxious to hedge their portfolios. Unless organized properly, the resulting increase of diversification options could only amplify periodic selling pressures on the dollar, and hence could add significantly to the overall degree of instability in exchange markets.

44. Certainly this might be so if the ECU, which at present is intended solely for use by central banks within the European Community, were to be made available to non-member central banks or private transactors as well. Such an asset, backed by the combined monetary reserves and economic strength of all nine Community countries, would obviously constitute a temptingly attractive investment medium, and hence could easily amplify periodic selling pressures on the dollar in the absence of appropriate precautions. As one European central banker has admitted:

If the ECU did ultimately become a reserve asset that could be

held by non-European official and private holders, no matter how organized the development was there would need to be continuous understandings and arrangements with the United States, and doubtless with Japan. Greater coordination of policies, particularly monetary policies, would be necessary, as well as dialogue and agreement with third countries to limit sudden, massive shifts in reserve preference. 36/

45. Fortunately, for the moment at least, such a development does not appear to be a matter for practical concern. In fact, according to European sources, no serious thought at all is presently being given to the possibility of enlarging the authorized range of ECU users (beyond perhaps the central banks of informal EMS "associates", such as Austria or Switzerland). Community officials are not eager to take on the burdens and responsibilities of an international reserve currency (which they regard as a potentially powerful constraint on the autonomy of Community monetary policy). But that by no means eliminates the danger of an exacerbated confidence problem, which in reality could develop even without any alteration of the formal rules governing ECU use. Two alternative possibilities suggest themselves.

46. First, it is possible that EMS will indeed succeed in creating a "zone of monetary stability". Effectively, this would make all of the participating currencies - and not just the stronger EC currencies, as formerly (para. 23) - attractive to dollar holders anxious to hedge their portfolios. Already, there is some evidence that advantage is being taken of the broadened investment opportunities provided by the links of the joint float. Funds now are attracted not only into traditional refuge currencies like the Deutschmark or the Dutch guilder, but even into the historically weaker ones like the French franc and Italian lira. With the probability of short-term fluctuations among these currencies reduced, investors can focus more on the higher interest rates on offer in the more inflation-prone countries; and in any event, even if central rates are realigned, exchange risks will be reduced, so long as alterations of exchange rates do not involve large discontinuous changes (para. 35). This certainly would seem to enhance the susceptibility of the dollar to periodic selling pressures.

47. The second possibility is that the private market will itself take on the role of promoting ECU use by non-member central banks or private transactors. In principle, there is nothing to prevent the development of assets denominated in ECU - or, for that matter, in any other artificial currency unit 37/ - by private financial institutions. The problem, in practice, is to back up the artificial currency unit with adequate facilities for deposits, lending, financing, and secondary market operations. To date, private-sector efforts to develop artificial currency units have not been notably successful, although recently there does seem to have been some spread of interest in SDR-denominated instruments. 38/ What distinguishes the ECU, however, from other artificial currency units (including the SDR), is that it is backed by a real political and economic structure, which should make prospects for ECU-denominated assets ultimately far more favourable. In fact, there has been no lack of proposals for initiatives by the private

sector since EMS was first launched. ^{39/} Should such proposals reach fruition, once again the susceptibility of the dollar to periodic selling pressures would seem to be enhanced.

48. Unlike the possibility of alterations in the formal rules governing ECU use, these two alternative possibilities do appear to be a matter for practical concern. Neither requires legislation by EMS participants; both already seem well on the way to reality. Indeed, both may be regarded as virtually inevitable: given the aspirations of the member-governments, they are, in a sense, no more than the logical outcome of the system's declared goal of a "zone of monetary stability" based on "full utilization of the ECU". Developing nations would thus be prudent to concern themselves with the consequently enhanced danger of destabilizing capital movements, unless appropriate precautions can be organized.

B. Inflationary Bias

49. There are two main reasons for concern that EMS might introduce an inflationary bias into EC policy and performance. First is the sizable expansion of the Community's mutual credit facilities (para. 9), which could allow participants to pursue somewhat easier monetary policies. And second is the inclusion of gold as well as dollars in the reserve pool backing the ECU (para. 8) which, in effect, increases the amount of usable reserves held by member central banks. On the face of it, the reserve pooling would not appear to involve any net increase of international liquidity: existing primary assets are simply transformed into an equivalent amount of ECU. But in reality, given the fact that for most central banks since 1971 monetary gold stocks had been effectively sterilized, the arrangement actually remonetizes 20 per cent of their gold reserves - and does so, moreover, at a market-related price far above that at which most had previously been valued. (The resulting mark-up of the members' aggregate reserves, when EMS was first launched, amounted to some \$14.4 billion.) A plausible implication is that governments might now be tempted to draw on this embarras de richesse to finance external deficits postponing anti-inflation policies that might otherwise be required.

50. These two concerns, it must be recognized, can be exaggerated. For instance, while it is true that the Community's credit facilities have been expanded, it is also true that little call has been made on them to date. And in any event the expansion, it may be argued, represents no more than the logical counterpart of the members' commitment to greater exchange-rate stability (which, other things being equal, implies a greater need for liquidity). Likewise, while it is true that the ECU pool has ostensibly increased the value of central bank gold stocks by denominating them at a market-related price, it is also true that the market price of gold is so highly volatile that, in practice, members might find it difficult to rely for long on this part of their reserves for deficit financing. And in any event, gold stocks had already been partially remonetized by the growing practice of using them, explicitly or implicitly, as collateral for official borrowing (as in the case of Italy's loan from the Federal Republic of Germany in 1975).

51. Nevertheless, it is difficult to be sanguine about these concerns. The potential for an inflationary bias is there - and unlike the hypothetical reverse danger of a deflationary bias (paras. 38-41), could well become serious in practical terms. Consider, for example, what could happen if and when sizable payments imbalances ever develop within EMS. Any disciplinary effect of the joint float on a deficit member is apt to be more than offset by the "safety value" of access to the credit facilities. It is not at all implausible to imagine participants being rather more "understanding" of the problems of a partner in trouble than, say, the IMF might be. EMS is based on a Community, after all: sympathetic support would seem to be more probable than a strict insistence on tough policy conditions. And the potential for an inflationary bias can only grow if and when ECU begin to be created against transfers of national currency (para. 27) or through activation of the credit facilities (para. 28), further encouraging easier monetary policies than would otherwise be possible. Developing nations may not need to worry about any secular tendency towards deflation in EMS. But they should be concerned about the potential for a systematic bias in the opposite direction, which could turn out to be quite marked.

C. The Special Drawing Right

52. The third possible danger of the liquidity and financing provisions of EMS is that they could erode the status of the Special Drawing Right and jeopardize future SDR allocations. Certainly, once again, this might be so if, as suggested above (paras. 44-48), the ECU does in fact become widely available to non-member central banks or to private transactors. Backed by the close-knit political and economic structure of the Community, such an asset would constitute a potentially powerful rival not only to the dollar but clearly to the SDR as well, whose backing in the membership of the International Monetary Fund is broader but also far less cohesive. European sources deny any intention to set up the ECU as a competitor to the SDR. But intended or not, it could happen in practice. As one otherwise sympathetic American observer has commented:

It will be confusing indeed to have two deliberately created reserve assets circulating: the SDR and the ECU... If damage ... is to be minimized, use of the ECU should be confined to settlement among members of the EMS and it should not circulate more widely either in the private market or among non-members of the EMS. 40/

53. However, even should the ECU not circulate more widely, there could be damage to the extent that the effective increase of liquidity inherent in EMS (para. 49) satiates the appetite of member-countries for future SDR allocations. Developing countries set great store by continued allocations of SDRs, which in effect provide them with a form of external financing considerably cheaper than equivalent amounts of loans from private credit markets. (The interest rate charged by the IMF on net SDR use, at 80 per cent of a weighted average of short-term rates in five major financial centres, is substantially below what developing countries would have to pay to borrow from the private markets - assuming they would be regarded as sufficiently creditworthy to be able to borrow at all.) This risk too is denied by European sources 41/, who insist that EC attitudes on SDR allocations have always

been guided by global rather than regional considerations. In reality, however, it is hard to see how the members' perception of global need would not somehow be influenced by the extent to which they themselves are experiencing inflationary pressures. Insofar as EMS does result in an inflationary bias, therefore, the possibility of a negative influence on their attitude towards future SDR allocations cannot entirely be excluded (particularly if, as in the past, developing countries continue to press for a "link" between SDR allocations and development assistance).

IV. INSTITUTIONAL ASPECTS

54. Institutional aspects of EMS could affect developing countries in two ways. More narrowly, further development of the system - and, in particular, of the European Monetary Fund - could have significant consequences for the role and authority of the International Monetary Fund. More broadly, further development of EMS could influence the momentum (or lack of it) towards reform of the international monetary system in general. Developing countries' interests are clearly tied up with both possibilities.

A. The IMF

55. As far as the IMF is concerned, EMS proponents readily concede the possibility of adverse consequences. In the words of one: "There is no point in dodging these issues." 42/ The Fund's traditionally central role in monetary affairs obviously would be challenged if, for example, EC countries chose to have recourse first - or, perhaps exclusively - to the EMF and/or their mutual credit facilities for any conditional payments financing they might need; and IMF authority would be further undermined if, in addition, the status of the Special Drawing Right were to be eroded. Developing countries have worked hard to build up their voice in the Fund's decision-making machinery. These efforts could go for naught if the IMF were to become a source of credit only for non-EMS countries, and the SDR were to become only a second-class asset vis-à-vis the ECU.

56. Once again, however, the practical importance of these issues is denied. 43/ In fact, EMS proponents stress, the scheme's credit facilities are neither new nor the only alternative source of official external financing available to members (who have all, for example, long participated in the Federal Reserve's network of swaps). Moreover, members have gone to great lengths to ensure that EMS operating rules and procedures remain fully compatible with those of the IMF; and in the one instance, to date, of activation of the short-term and medium-term credit facilities (on behalf of Italy, in 1974-75), considerable care was taken to coordinate the amount and terms of lending with a parallel Fund stand-by operation. Launching their regional initiative, Europeans stress, is in no way intended to signal diminution of support for the IMF. On the contrary, insofar as Community countries do choose to go first to EMS credit mechanisms, the main result will simply be to free a larger proportion of Fund resources for lending to developing countries - presumably a distinct gain from the developing countries'

point of view.

57. Still, one cannot help but wonder how the IMF will be able to retain its central role in international monetary management so long as some of its largest members always have the option of going elsewhere to obtain official external financing. In principle, under the amended Articles of Agreement, the Fund is supposed to exercise surveillance over the policies of all its members - debtors and creditors alike - through each country's annual economic consultations, as well as in the course of the Fund's periodic discussions of the world economic outlook. But in practice the only effective influence wielded by the Fund is still on debtors alone, through the power of the purse. It remains an open question, therefore, whether - or to what extent - it will now be able to influence the policies of non-borrowing countries as well. Ultimately, the answer will depend on the attitude of the EMS participants themselves - whether they will choose to use the enlarged resources of their regional system to by-pass (and, in the process, diminish) the authority of the IMF; or rather to cooperate with the Fund and other financial powers to strengthen the fabric of international monetary cooperation. Put differently, it will depend on whether, in the end, their attitude turns out to be more "outward-looking" or "inward-looking".

B. Monetary Reform

58. Here, plainly, the narrow issue of the IMF merges into the broader issue of monetary reform in general - and indeed, it is on these more general grounds that the institutional impact of EMS should most appropriately be judged. Most international monetary specialists concur on two observations: (1) the monetary system - or "non-system", as some describe it - has many problems; and (2) universal solutions to these problems are unlikely. Although earlier in the post-World War II era a certain degree of order and stability in global monetary relations was assured by the predominant position of the United States and the dollar, conditions for unilateral American leadership (or "hegemony") are no longer propitious. Yet the community of nations still shows no sign of willingness to submit to the rigors of either a self-disciplining regime of automatic and binding rules or a world central bank. In current circumstances, therefore, solutions must be found on a more decentralized basis, in efforts at shared responsibility and decision-making among countries prepared for more intense cooperation than as yet seems feasible on a global scale. If there is one point on which EMS proponents and skeptics agree, it is that Europe's initiative could aid in such efforts. In the words of one proponent:

I am convinced that the success of the EMS experiment towards its basic objective, and of the indispensable cooperation between the EMS and U.S. authorities, might at long last break the deadlock which has paralyzed, since Jamaica, the previous determination to restore a workable world monetary order. 44/

Likewise, this author has written elsewhere:

The EMS could enable the Europeans to speak with one voice and thus greatly enhance their overall bargaining strength in

international monetary discussions. A regime of shared responsibility could then be established that ... would have a better chance of producing concord instead of conflict. In place of an obsolete hegemony, a new organizing principle of cooperative management would finally be within reach. 45/

59. But the question remains: would Europe's initiative produce this happy result? Or might it instead (as even one of the system's principal enthusiasts fears it could) become "at best a mere inward-looking oasis" 46/ dedicated to insulating its members from a world of continuing monetary chaos? Obviously, this is not a question that can be answered a priori. Once again, the proof of the pudding will be in the eating - specifically, in the extent to which (and speed with which) the Europeans move towards genuine dialogue and cooperation with non-members on major monetary issues. The task for developing countries will be to help push Europe in this positive direction.

V. CONCLUSIONS

60. From the point of view of developing countries, the European Monetary System - for all its evident attractions - is not without risks. Clearly, developing countries would benefit if the Community can in fact attain its objective of a "zone of monetary stability" in Europe. And their interests should be served as well if, in addition, EMS is also able to help regain momentum in the process of global monetary reform. But dangers exist too. Unless the issues of convergence and a joint dollar policy can be satisfactorily resolved, EMS could end up increasing rather than decreasing overall instability of exchange rates; and exchange instability would be further exacerbated if, in addition, destabilizing capital movements and portfolio shifts are amplified as a result of the increase of diversification options inherent in the scheme. Furthermore, EMS risks introducing an inflationary bias into the economic policy and performance of the countries of the European Community and could erode the status of the International Monetary Fund and the Special Drawing Right, as well as jeopardize future SDR allocations. Not that these dangers should be exaggerated: although possible, they are by no means certain; and much will depend on the attitude and actions of the members themselves, which can hardly be predicted in advance. But they ought not to be ignored altogether. For developing countries, prudent caution rather than unquestioning confidence would seem to be the most appropriate response.

FOOTNOTES

1. Jenkins (1977). For a discussion of initial reactions to Mr. Jenkins' efforts, see Hogg (1978).
2. The Council resolution establishing EMS is reproduced in an Appendix to this paper.
3. For more detail on the EMS exchange-rate mechanism, see Bank of England (1979); IMF (1979), pp. 97-98; and U.S. Congress (1979), ch.2.
4. See Appendix, Part A, para. 1.4.
5. See Appendix, Part B; and Emerson (1979), pp. 40-41.
6. See e.g. Brittan (1978, 1979); Thornton (1979); Vaubel (1980).
7. European Commission (1980), pp. 31-32. The 1.9 per cent figure is biased slightly upwards owing to the inclusion in the overall Community average of the pound sterling which, as can be seen in Table 2, fluctuated more against the ECU in 1979 than all but two other Community currencies.
8. Although neither Britain nor Italy is a full member of the EMS, their currencies, as indicated (Table 1), form part of the ECU basket. While the ECU rates against which divergence limits are calculated are adjusted to compensate for movements of these two currencies beyond what would be permitted if they were full members, adjustment is not perfect. Inclusion of the two at a time when both are rising tends to make other strong participating currencies look relatively weaker. For technical discussions, see Bank of England (1979); and IMF (1979), p. 98.
9. See e.g., Marsh (1979).
10. BIS (1980), p. 143.
11. BIS (1980), p. 172.
12. See e.g., Baquias (1979); Emerson (1979); Livingston (1980); McMahon (1979); Thygesen (1979a, 1979b); Triffin (1979a, 1979c, 1980a); Van Ypersele (1979, 1980).
13. In addition to the references cited in note 6, see e.g., Cohen (1979a, 1979b); De Grauwe and Peeters (1979); Shadow European Economic Policy Committee (1979); Vaubel (1979).
14. In addition to the references in the previous two notes, see The Banker (1979); Burgard (1980); Coffey (1979); Solomon (1979); Triffin (1979b); Trezise (1979); U.S. Congress (1979), ch. 3-4; Vila (1979).
15. Van Ypersele (1979), p. 8.

16. BIS (1980), p. 143.
17. Marjolin Committee (1975), p. 3. See also Tsoulakis (1977), Part 2.
18. Hirsh (1972), p. 57.
19. These and other references to European sources are based on interviews in Brussels, Bonn, and Paris, August 14-18, 1980.
20. De Grauwe and Peeters (1979), p. 45. Italics supplied.
21. Van Ypersele (1979), p. 10.
22. Appendix, Part A, para. 5.1.
23. Swoboda (1979), p. 84.
24. U.S. Congress (1979), pp. 145-146.
25. Appendix, Part A, para. 1.4.
26. IMF (1978), pp. 39-40.
27. See e.g., Cohen (1979a, 1979b); De Grauwe and Peeters (1979); Shadow European Economic Policy Committee (1979); Thornton (1979); U.S. Congress (1979), ch. 3-4; Vaubel (1980); Vila (1979).
28. See e.g., McMahon (1979); Thygesen (1979a, 1979b); Van Ypersele (1979, 1980).
29. Thygesen (1979a), p. 106.
30. Appendix, Part A, para. 3.1.
31. Appendix, Part A, para. 3.6.
32. Thygesen (1979b), p. 4.
33. See e.g., Van Ypersele (1980).
34. See e.g., Emerson (1979); Thygesen (1979a); Van Ypersele (1979).
35. See e.g., Thygesen (1979c).
36. McMahon (1979), p. 90. See also Triffin (1979c), p. 284, and (1980a), p. 42.
37. See Aschheim and Park (1976).
38. In May 1980 it was reported that at least thirty commercial banks in twelve financial centres were now offering SDR-denominated deposits, as against only about a half-dozen two years earlier (although the total volume of these deposits was still probably no more than SDR 3 billion or so). See Helleiner (1980), p. 12.

39. See e.g., Coussement (1979); Triffin (1980b); Ugeux (1978).
40. Solomon (1979), pp. 8-9. See also McMahon (1979), p. 91.
41. See e.g., Baquiast (1979), p. 55.
42. McMahon (1979), p. 91.
43. See e.g., Baquiast (1979), pp. 55-56; McMahon (1979), pp. 90-91.
44. Triffin (1980a), p. 45.
45. Cohen (1979b), pp. 42-43.
46. Triffin (1979c), p. 286.

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ANNEX I

Table 1Currency Weights of the European Currency Unit (ECU)

	In Absolute Amounts of Currency	As Percentage Shares on the Basis of Markets Rates on March 1, 1979
Deutschmark	0.82800	33.02
French franc	1.15000	19.89
Pound sterling	0.08850	13.25
Netherlands guilder	0.28600	10.56
Italian lira	109.00000	9.58
Belgian franc	3.66000	9.23
Danish krone	0.21700	3.10
Irish pound	0.00759	1.11
Luxembourg franc	0.14000	0.35

Source: European Commission.

Table 2Exchange-Rate Fluctuations^{a/} in the European Community, 1979

	Quarters				Year
	1	2	3	4	
Belgian franc/ Luxembourg franc	0.1	1.8	0.3	0.6	0.3
Danish krone	0.1	2.4	1.7	2.0	2.7
Deutschmark	0.2	0.5	0.0	1.6	2.0
French franc	0.3	0.9	0.9	1.0	1.6
Irish pound	0.7	1.0	0.8	0.7	0.8
Italian lira	1.8	0.7	0.6	1.7	5.4
Netherlands guilder	0.7	1.4	0.9	0.7	0
Pound sterling	0.7	4.7	2.7	4.7	2.7
Community average	0.6	1.7	1.0	1.6	1.9
US dollar	1.1	0.5	2.1	1.2	4.2
Japense yen	6.9	6.3	4.8	10.5	12.5

Source: European Commission.

^{a/} Percentage change in the quarterly or annual average of daily rates against the ECU from the corresponding average in the previous quarter or year, respectively. It will, therefore, be noted that annual figures are not averages of quarterly figures.

Table 3

Official Discount Rate Changes in the European
Monetary System, March-September 1979

Date	Country	Previous Rate (%)	New Rate (%)
March 13 30	EMS inaugurated Germany <u>a/</u>	3.00	4.00
April	[No changes]		
May 2 30 30	Belgium Belgium Netherlands	6.00 7.00 6.50	7.00 8.00 7.00
June 13 15 22 29	Belgium Denmark Ireland Belgium	8.00 8.00 11.85 9.00	9.00 9.00 13.70 11.00
July 6 13 13	Netherlands Netherlands Germany <u>a/</u>	7.00 7.50 4.00	7.50 8.50 5.00
August	[No changes]		
September 17 24	Denmark Exchange rates realigned (DM revalued 2% and the Danish krone devalued by 3% against all other currencies)	9.00	11.0

Source: Morgan Guaranty Bank, World Financial Markets, various issues.

a/ In addition to its discount-rate changes in March and July, Germany also raised its Lombard rate in March (from 4.00 to 5.00 per cent) and in June (from 5.00 to 5.50 per cent). (The Lombard rate is the rate at which the Bundesbank lends to commercial banks against the collateral of securities.)

Table 4

Central Rates of European Community Currencies vis-à-vis
the ECU, 1979

(units of national currency per ECU)

	12 March 1979	24 September 1979	% change
Belgian franc/ Luxembourg franc	39.4582	39.8456	+0.98
Netherlands guilder	2.72077	2.74748	+0.98
Danish krone	7.08592	7.36594	+3.95
Deutschmark	2.51064	2.48557	-1.00
Italian lira	1.148.15	1.159.42	+0.98
French franc	5.79831	5.85522	+0.98
Irish pound	0.662638	0.669141	+0.98

Source: European Commission.

Note: - = revaluation of national currency.

Table 5

Price Performance^{a/} in the European Community, 1979-1980

	1978	1979	1979				1980
			I	II	III	IV	I
Belgium	4.5	4.4	3.8	4.1	4.7	5.1	6.3
Denmark	10.1	9.6	6.9	7.9	12.0	11.6	13.3
France	9.1	10.7	10.2	10.1	10.8	11.5	13.3
Germany	2.8	4.1	3.0	3.4	4.8	5.4	5.4
Ireland	7.6	13.2	10.8	12.4	13.6	16.0	15.6
Italy	12.1	14.7	12.9	13.6	14.8	17.7	20.8 ^{b/}
Netherlands	4.1	4.2	4.2	4.2	3.9	4.6	5.7
United Kingdom	8.3	13.4	9.6	10.6	16.0	17.3	19.0

Source: International Monetary Fund, International Financial Statistics.

^{a/} Percentage changes of consumer price indices over corresponding period of previous year.

^{b/} Based on January-February only.

Table 6

Divergence of Price Performance in the European Community,
1978-1979

	Mini-max range between Member States (consumer prices)	Standard deviation		
		Consumer prices	Consumer prices, manufactured goods only	Wholesale prices, manufactured goods only
1978	9.4	3.17	2.54	4.05
1979	10.7	4.19	3.47	3.83
1978 I	12.8	3.99	3.99	3.32
II	8.9	2.93	2.34	2.83
III	9.7	3.40	2.80	4.07
IV	10.2	3.48	2.74	4.10
1979 I	9.7	3.43	2.16	3.42
II	10.9	4.08	2.46	2.61
III	16.4	5.82	7.24	3.57
IV	17.0	6.34	9.28	4.87

Source: European Commission.

Note: Quarterly figures are based upon seasonally adjusted price changes at annual rates.

Table 7

Price Performance in the European Community, 1978-1980
(percentage changes)

	Belgium	Denmark	France	Germany	Ireland	Italy	Nether- lands	United Kingdom	EC
<u>Consumer prices</u>									
1978	4.4	9.4	8.1	2.5	7.9	12.7	4.2	8.6	7.1
1979	4.5	9.5	10.5	4.1	13.2	15.0	4.7	13.2	9.0
1980 P	6.9	12.5	12.1	5.0	15.5	17.1	6.8	18.9	11.3
<u>GDP Price Deflator</u>									
1978	4.5	9.6	9.3	3.9	11.3	13.3	5.3	10.3	8.2
1979	4.9	7.3	10.2	3.7	12.9	15.9	4.3	14.1	8.8
1980 P	6.7	10.2	11.0	4.5	14.9	16.7	6.9	21.6	10.9

Source: European Commission.

Note: P = projections.

Resolution of the European Council of 5 December 1978 on the
establishment of the European Monetary System (EMS) and
related matters

A.

The European Monetary System

1. Introduction

1.1 In Bremen we discussed a scheme for the creation of closer monetary co-operation leading to a zone of monetary stability in Europe. We regarded such a zone as a highly desirable objective and envisaged a durable and effective scheme.

1.2 Today, after careful examination of the preparatory work done by the Council and other Community bodies, we are agreed as follows: a European Monetary System (EMS) will be set up on 1 January 1979.

1.3 We are firmly resolved to ensure the lasting success of the EMS by policies conducive to greater stability at home and abroad for both deficit and surplus countries.

1.4 The following chapters deal primarily with the initial phase of the EMS.

We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created. This system will entail the creation of the European Monetary Fund as announced in the conclusions of the European Council meeting at Bremen on 6-7 July 1978, as well as the full utilization of the ECU as a reserve asset and a means of settlement. It will be based on adequate legislation at the Community as well as the national level.

2. The ECU and its functions

2.1 A European Currency Unit (ECU) will be at the centre of the EMS. The value and the composition of the ECU will be identical with the value of the EUA at the outset of the system.

2.2 The ECU will be used a) as the denominator (numéraire) for the exchange rate mechanism; b) as the basis for a divergence indicator; c) as the denominator for operations in both the intervention and the credit mechanism; d) as a means of settlement between monetary authorities of the EC.

2.3 The weights of currencies in the ECU will be re-examined and if necessary revised within six months of the entry into force of

the system and thereafter every five years or, on request, if the weight of any currency has changed by 25 per cent.

Revisions have to be mutually accepted. They will, by themselves, not modify the external value of the ECU. They will be made in line with the underlying economic criteria.

3. The exchange rate and the intervention mechanism

3.1 Each currency will have an ECU-related central rate. These central rates will be used to establish a grid of bilateral exchange rates. Around these exchange rates fluctuation margins of ± 2.25 per cent will be established. EC countries with presently floating currencies may opt for wider margins up to ± 6 per cent at the outset of the EMS. These margins should be gradually reduced as soon as economic conditions permit to do so.

A member state which does not participate in the exchange rate mechanism at the outset may participate at a later date.

3.2 Adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission. There will be reciprocal consultation in the Community framework about important decisions concerning exchange rate policy between countries participating and any country not participating in the system.

3.3 In principle, interventions will be made in participating currencies.

3.4 Intervention in participating currencies is compulsory when the intervention points defined by the fluctuation margins are reached.

3.5 An ECU basket formula will be used as an indicator to detect divergences between Community currencies. A threshold of divergence will be fixed at 75 per cent of the maximum spread of divergence for each currency. It will be calculated in such a way as to eliminate the influence of weight on the probability to reach the threshold.

3.6 When a currency crosses its threshold of divergence, this results in a presumption that the authorities concerned will correct this situation by adequate measures, namely a) diversified intervention; b) measures of domestic monetary policy; c) changes in central rates; d) other measures of economic policy.

In case such measures, on account of special circumstances, are not taken, the reasons for this shall be given to the other authorities, especially in the concertation between central banks. Consultations will, if necessary, then take place in the appropriate Community bodies, including the Council of Ministers. After six months these provisions shall be reviewed in the light of experience. At that date the questions regarding imbalances accumulated by divergent creditor or debtor countries will be studied as well.

3.7 A very short-term facility of an unlimited amount will be established. Settlements will be made 45 days after the end of the month of intervention with the possibility of prolongation for another three months for amounts limited to the size of debtor quotas in the short-term monetary support.

3.8 To serve as a means of settlement, an initial supply of ECUs will be provided by the EMCF against the deposit of 20 per cent of gold and 20 per cent of dollar reserves currently held by central banks.

This operation will take the form of specified, revolving swap arrangements. By periodical review and by an appropriate procedure it will be ensured that each central bank will maintain a deposit of at least 20 per cent of these reserves with the EMCF.

A member state not participating in the exchange rate mechanism may participate in this initial operation on the basis described above.

4. The credit mechanisms

4.1 The existing credit mechanisms with their present rules of application will be maintained for the initial phase of the EMS. They will be consolidated into a single fund in the final phase of the EMS.

4.2 The credit mechanisms will be extended to an amount of ECU 25 billion of effectively available credit. The distribution of this amount will be as follows: short-term monetary support - ECU 14 billion, medium-term financial assistance - ECU 11 billion.

4.3 The duration of the short-term monetary support will be extended for another three months on the same conditions as the first extension.

4.4 The increase of the medium-term financial assistance will be completed by 30 June 1979. In the meantime, countries which still need national legislation are expected to make their extended medium-term quotas available by an interim financing agreement of the central banks concerned.

5. Third countries and international organizations

5.1 The durability of the EMS and its international implications require co-ordination of exchange rate policies vis-à-vis third countries and, as far as possible, a concertation with the monetary authorities of those countries.

5.2 European countries with particularly close economic and financial ties with the European Communities may participate in the exchange rate and intervention mechanism.

Participation will be based upon agreements between central banks. These agreements will be communicated to the Council and the Commission of the EC.

5.3 The EMS is, and will remain, fully compatible with the relevant articles of the IMF Agreement.

6. Further procedure

6.1 To implement the decisions taken, the European Council requests the Council of Economics and Finance Ministers to consider and to take a decision on 18 December 1978 on the following proposals of the Commission.

a) Council Regulation modifying the unit of account used by the European Monetary Co-operation Fund, which introduces the ECU in the operations of the EMCF and defines its composition.

b) Council Regulation permitting the EMCF to receive monetary reserves and to issue ECUs to the monetary authorities of the member states which may use them as a means of settlement.

c) Council Regulation on the impact of the European Monetary System on the Common Agricultural Policy.

The European Council considers that the introduction of the EMS should not of itself result in any change in the situation obtaining prior to 1 January 1979 regarding the expression in national currencies of agricultural prices, monetary compensatory amounts and all other amounts fixed for the purposes of the Common Agricultural Policy.

The European Council stresses the importance of henceforth avoiding the creation of permanent MCAs and progressively reducing present MCAs in order to re-establish the unity of prices of the Common Agricultural Policy, giving also due consideration to price policy.

6.2 It requests the Commission to submit in good time a proposal to amend the Council Decision of 22 March 1971 on the introduction of a mechanism for medium-term financial support to enable the Council of Economics and Finance Ministers to take a decision on such proposal at its session on 18 December 1978.

6.3 It requests the central banks of member states to modify their agreement of 10 April 1972 on the reduction of margins of fluctuation between the currencies of member states in accordance with the rules set forth above.

6.4 It requests the central banks of member states to modify as follows the rules on short-term monetary support by 1 January 1979 at the latest.

a) The total of debtor quotas available for drawings by the central banks of member states shall be increased to an aggregate amount of ECU 7.9 billion.

b) The total of creditor quotas made available by the central banks of member states for financing the debtor quotas shall be increased to an aggregate amount of ECU 15.8 billion.

c) The total of the additional creditor amount as well as the total of the additional debtor amount may not exceed ECU 8.8 billion.

d) The duration of credit under the extended short-term monetary support may be prolonged twice for a period of three months.

B.

Measures designed to strengthen the economies of the less prosperous member states of the European Monetary System

1. We stress that, within the context of a broadly based strategy aimed at improving the prospects of economic development and based on symmetrical rights and obligations of all participants, the most important concern should be to enhance the convergence of economic policies towards greater stability. We request the Council (Economic and Finance Ministers) to strengthen its procedures for co-ordination in order to improve that convergence.

2. We are aware that the convergence of economic policies and of economic performance will not be easy to achieve. Therefore, steps must be taken to strengthen the economic potential of the less prosperous countries of the Community. This is primarily the responsibility of the member states concerned. Community measures can and should serve a supporting role.

3. The European Council agrees that in the context of the European Monetary System the following measures in favour of the less prosperous member states effectively and fully participating in the exchange rate and intervention mechanisms will be taken.

3.1 The European Council requests the Community institutions by the utilization of the new financial instrument and the European Investment Bank to make available for a period of five years loans of up to 1,000 million EUA per year to these countries on special conditions.

3.2 The European Council requests the Commission to submit a proposal to provide interest rate subsidies of 3 per cent for these loans, with the following elements: the total cost of this measure, divided into annual tranches of 200 million EUA each over a period of five years, shall not exceed 1,000 million EUA.

3.3 Any less prosperous member country which subsequently effectively and fully participates in the mechanisms would have the right of access to this facility within the financial limits mentioned above. Member states not participating effectively and fully in the mechanisms will not contribute to the financing of the scheme.

3.4 The funds thus provided are to be concentrated on the financing of selected infrastructure projects and programmes, with the understanding that any direct or indirect distortion of the competitive position of specific industries within member states will have to be avoided.

3.5 The European Council requests the Council (Economics and Finance Ministers) to take a decision on the above-mentioned proposals in time so that the relevant measures can become effective on 1 April 1979 at the latest. There should be a review at the end of the initial phase of the EMS.

4. The European Council requests the Commission to study the relationship between greater convergence in economic performance of the member states and the utilization of Community instruments, in particular the funds which aim at reducing structural imbalances. The results of these studies will be discussed at the next European Council.

Agreement between the central banks of the Member States of the
European Economic Community laying down the operating procedures
for the European Monetary System

The central banks of the Member States of the European Economic Community.

Having regard to the Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters;

Having regard to Regulation (EEC) No. 907/73 of the Council of the European Communities of 3 April 1973 establishing a European Monetary Co-operation Fund;

Having regard to Resolution (EEC) No. 3180/78 of the Council of the European Communities of 18 December 1978 changing the value of the unit of account used by the European Monetary Co-operation Fund;

Having regard to Regulation (EEC) No. 3181/78 of the Council of the European Communities of 18 December 1978 concerning the European Monetary System;

Whereas the European Council has agreed to set up a scheme for the creation of closer monetary co-operation leading to a zone of monetary stability in Europe;

Whereas the said Resolution provides that a European currency unit, the ECU shall be at the centre of the European Monetary System and that the value and composition of the ECU shall, initially, be identical with the value and composition of the European unit of account (EUA);

Whereas under the terms of the said Resolution:

(i) each currency will have an ECU-related central rate and the central rates will be used to establish a grid of bilateral parities or central rates;

(ii) fluctuation margins of 2.25 per cent will be fixed around these bilateral central rates, although Member States not all present participating in the narrower margins mechanisms may in the initial stage of the European Monetary System opt for wider margins of up to 6 per cent, which must be progressively reduced as soon as economic conditions permit.

Whereas the said Resolution further provides that a formula for an ECU-based basket shall be used as an indicator to detect divergences between Community currencies and sets out the principles governing the operation of this indicator, which will be re-examined at the end of a period of six months.

Whereas this re-examination will also cover questions regarding imbalances accumulated by divergent creditor or debtor countries;

Whereas a Member State that does not initially participate in the exchange-rate mechanism can do so at a later date and whereas it is therefore advisable to ensure co-operation between the central bank of such a State and the central banks of the participating States;

Whereas very short-term credit facilities of unlimited amount will be created;

Whereas the European Council has asked the central banks of the Member States of the Community to amend their Agreement of 10 April 1972 on the narrowing of the margins of fluctuation between the currencies of the Member States so as to embody the rules set forth in the said Resolution;

Whereas in order to make provision for means of settlement the central banks have been asked initially to transfer to the European Monetary Co-operation Fund in the form of revolving swaps against ECUs, 20 per cent of their gold holdings and 20 per cent of their US dollar reserves, and thereafter to keep at least 20 per cent of the said reserves on deposit with the European Monetary Co-operation Fund;

Have agreed as follows:

I Exchange rate mechanism

Article 1 - Central rates in terms of the ECU

Each participating central bank shall notify the Secretariat of the Committee of Governors of the Central Banks of the Member States of the European Economic Community of a central rate in terms of the ECU for its currency. The Secretariat shall pass on this information to the other central banks and the European Communities.

Article 2 - Intervention rules

2.1 Each participating central bank shall notify the Secretariat of the Committee of Governors of the rates for compulsory intervention expressed in its currency, and the Secretariat shall pass on this information to the other central banks. These rates shall be fixed in relation to the bilateral central rates derived from the central rates in terms of the ECU referred to in Article 1 of the present Agreement. The market shall be notified of them.

2.2 Interventions shall, in principle, be effected in currencies of the participating central banks. These interventions shall be unlimited at the compulsory intervention rates. Other interventions in the foreign exchange market shall be conducted in accordance with the relevant guidelines that were adopted by the Committee of Governors in its Report of 9 December 1975 or that may be adopted in the future, or shall be subject to concertation among all the participating central banks.

Article 3 - Operation of the indicator of divergence

3.1 On either side of the central rate for its currency in terms of the ECU each participating central bank shall establish rates for its currency in terms of the ECU that will constitute thresholds of divergence. These thresholds of divergence shall be calculated in such

a way as to neutralize the influence of the differences in weights on the probability of their being reached; they shall be set at 75 per cent of the maximum divergence spread, this being measured by the percentage difference between the daily rate and the central rate of a currency against the ECU when that currency is standing at the opposite pole from all the other currencies at the compulsory intervention rates referred to in Article 2.1 of the present Agreement. The necessary steps shall be taken to take account of the effects of the adoption of different maximum margins of fluctuation for the participating currencies and of the possible non-participation of a currency in the exchange rate mechanism.

3.2 If a currency crosses a divergence threshold, this shall entail the consequences set out in paragraph 3.6 of the Resolution of the European Council of 5 December 1978.

Article 4 - Method of calculating the values of the ECU in each currency

For the purposes of the operation of the indicator of divergence provided for under Article 3 of the present Agreement, the market value of the ECU in each currency shall be calculated by a uniform method as frequently as necessary and at least on the occasion of each daily concertation session among central banks.

Article 5 - Non-participation

Any central bank that is not participating in the exchange rate mechanism shall co-operate with the other central banks in the concertation and the other exchanges of information necessary for the proper functioning of the exchange rate mechanism.

II Very short-term financing

Article 6 - Basic principles

6.1 To enable interventions to be made in Community currencies, the participating central banks shall open for each other very short-term credit facilities, unlimited in amount, in accordance with the conditions set out in Articles 7 to 16 of the present Agreement.

6.2 The financing operations concluded in this connection shall take the form of spot sales and purchases of Community currencies against the crediting or debiting of accounts denominated in ECUs with the European Monetary Co-operation Fund (hereafter referred to as EMCF).

Article 7 - Accounting procedures

7.1 The accounts opened for the central banks in the books of the EMCF shall be denominated in ECUs. The conversion of currencies into ECUs shall be effected at the daily rates for the ECU as established by the Commission's staff on the basis of the method adopted. The relevant rates shall be those ruling on the day on which the interventions were made.

7.2 The value date of the financing operations shall be identical with the value date of the interventions in the market.

Article 8 - Remuneration

8.1 The debtor and creditor interest rates applying to very short-term financing operations shall be the average of the official discount rates of all EEC central banks, weighted in accordance with their respective currencies' weights as derived from the ruling ECU central rates. This average shall be calculated once a month on the basis of the discount rates ruling on the last working day of the month and shall apply during the following month to all outstanding amounts in respect of very short-term financing operations.

8.2 Accrued interest shall be paid in ECUs at each monthly settlement date or between settlement dates at the same time as advance liquidation of a debtor balance is effected.

Article 9 - Initial settlement date

The initial settlement date for a very short-term financing operation shall be the last working day preceding the sixteenth day of the second month following that in which the value date of the intervention fell.

Article 10 - Automatic renewal

At the request of the debtor central bank, the initial settlement date for a financing operation may be extended for a period of three months.

However:

- (a) any initial settlement date may only be automatically extended once for a maximum of three months;
- (b) recourse may only be had to the renewal facility referred to above if the relevant debt does not thereby remain continuously outstanding for more than six consecutive months;
- (c) the total amount of indebtedness resulting from application of the present Article may at no time exceed a ceiling equal to the debtor quota of the central bank concerned under the short-term monetary support arrangement;
- (d) if a central bank has recourse to the additional automatic borrowing facility for six consecutive months, the Committee of Governors shall take steps to ascertain whether the payments deficit of the country concerned is such that recourse to other means of financing in particular Short-term Monetary Support or Medium-Term Financial Assistance within the EEC, would be more appropriate.

Article 11 - Renewal by mutual agreement

11.1 Any debt exceeding the ceiling laid down in Article 10(c) of this Agreement may be renewed once for three months subject to the agreement of the creditor or creditors in the EMCF.

11.2 Any debt already renewed automatically for three months may be renewed a second time for a further three months subject to the agreement of the creditor or creditors in the EMCF.

11.3 Debts and claims thus extended by mutual agreement shall be settled separately outside the provisions of Articles 12, 13 and 14 of this Agreement without prejudice, however, to the priority accorded to settlements carried out under those Articles. Offsetting or advance settlement of debts and claims of the kind for which provision is made in the present Article shall be subject to the agreement of all creditors and debtors in the EMCF, whatever their status.

Article 12 - Order of repayment of claims

12.1 Claims arising from financing operations carried out in accordance with Articles 9 and 10 above shall be settled in order of priority; however, if a central bank's claim exceeds the amount of its creditor quota under the Short-term Monetary Support arrangement, that central bank may request that the excess be treated for purposes of the next settlement as equal in seniority to the most senior claims of other creditor central banks.

12.2 All claims arising within the same monthly accounting period shall be regarded as of equal seniority. When a settlement covers a number of claims regarded as of equal seniority, each of the components of the settlement shall be distributed in proportion to the respective amounts of the claims.

12.3 The rules governing the order or distribution of settlements may be departed from subject to the agreement of all the parties to the financing operations carried out in accordance with Articles 9 and 10 of the present Agreement.

Article 13 - Automatic offsetting

13.1 All the debts and claims of a single central bank arising from the operations provided for under Articles 9 and 10 of the present Agreement shall, where appropriate, be automatically offset against each other.

13.2 Any new liability shall be offset against the most senior claim of the same central bank. Any new claim shall be offset against the most senior debt of the same central bank.

Article 14 - Advance payment

14.1 Any debtor balance recorded in accordance with Articles 9 and 10 of the present Agreement may be settled in advance at the request of the debtor central bank.

- (i) at any time in the currency of a creditor in the EMCF under Articles 9 and 10 of the present Agreement;
- (ii) on the monthly settlement date by transfer of the means of settlement provided for in Article 16 of the present Agreement.

14.2 Any advance repayment shall be applied first to the most senior liabilities contracted under Article 10 of the present Agreement.

Article 15 - Working balances

The central banks may hold working balances in Community currencies

within the limits laid down by the Committee of Governors. These limits may be exceeded only with the consent of the central bank concerned.

Article 16 - Means of settlement

16.1 When a financing operation falls due, settlement shall be carried out - in so far as it has not been settled in the first instance by means of holdings in the creditor's currency - entirely or in part by transferring ECUs, with the proviso that a creditor central bank shall not be obliged to accept settlement by means of ECUs of an amount more than 50 per cent of its claim which is being settled. The balance shall be settled by transferring other reserve components in accordance with the composition of the debtor central bank's reserves as at the end of the month preceding the settlement.

These provisions shall be without prejudice to other forms of settlement agreed between creditor and debtor central banks.

Debtor balances in ECUs settled by means of assets denominated in currencies and in SDRs shall be converted into such assets on the basis of the daily rates for the ECU established by the Commission's staff.

16.2 For the purpose of the preceding paragraph the composition of the debtor's reserves shall be determined on the basis of assets denominated in SDRs and in currencies. Nevertheless, gold holdings may also be taken into account if the price proposed by the debtor central bank was accepted by the creditor central bank. As far as assets denominated in SDRs and in currencies are concerned, the debtor central bank may choose which assets it will deliver in settlement.

16.3 If the debtor central bank no longer possesses ECUs and wishes to acquire some, it shall apply in the first instance to central banks that are net accumulators of ECUs or possibly to the EMCF. In the latter case, the ECUs shall be acquired against the contribution of an equal percentage of the gold and dollar assets held by that central bank.

III Creation, utilization and remuneration of ECUs

Article 17 - Creation of ECUs against contributions of gold and dollars

17.1 Each central bank participating in the exchange rate mechanisms outlined in Chapter I of the present Agreement shall contribute to the EMCF 20 per cent of its gross dollar reserves as at the last working day of the month preceding the month in which the present Agreement takes effect: it shall be credited by the EMCF with an amount of ECUs corresponding to these contributions.

Central banks that are not participating in the exchange rate mechanism referred to above may likewise make contributions in accordance with the terms of the preceding subparagraph.

17.2 The contributions referred to in Article 17.1 of the present Agreement shall be made available in the case of the participating central banks at the latest ten working days after the implementation of the present Agreement or in the case of the non-participating central banks at the time of exercising the option referred to above.

17.3 The contributions of gold and dollars shall take the form of three-month revolving swaps against ECUs which may be unwound at two working days' notice. These operations shall be concluded at flat rates.

17.4 For the purpose of the swap operations referred to in the present Article, the value of the reserve components transferred to the EMCF shall be established as follows:

(i) for the gold portion, the average of the prices converted into ECUs, recorded daily at the two London fixings during the previous six calendar months, but not exceeding the average price of the two fixings on the penultimate working day of the period;

(ii) for the dollar portion, the market rate two working days prior to the value date.

17.5 Contracts shall be concluded between each central bank and the EMCF detailing the arrangements for the delivery of the gold and dollars to the EMCF and for their management in so far as this is entrusted to the central banks.

17.6 At the beginning of each quarter, when the swaps referred to in the present Article are renewed, the central banks and the EMCF shall make the necessary adjustments to these swaps, firstly to ensure that each central bank's contribution to the EMCF continues to represent at least 20 per cent of its gold and dollar reserves on the basis of its gross reserve positions recorded on the last working day of the preceding quarter and secondly, to take account of any price or rate changes that may have occurred since the initial contribution or previous adjustment.

Article 18 - Utilization of ECUs

18.1 ECU assets shall be used in intra-Community settlements within the limits and on the terms set out in Article 16 of the present Agreement.

18.2 The central banks may transfer ECUs to one another against dollars, EEC currencies, Special Drawing Rights or gold.

18.3 For the purposes of meeting a decline in its dollar reserves a central bank may acquire dollars against ECUs from the EMCF between two periodic adjustments initially by unwinding a swap transaction.

18.4 The operations referred to in Articles 18.2 and 18.3 of the present Agreement shall not be carried out for the sole purpose of altering the composition of a central bank's reserves.

Article 19 - Remuneration

19.1 Central banks whose ECU assets are less than their forward sales of ECUs shall pay interest to the EMCF on the difference between these two aggregates. The EMCF shall pay central banks whose ECU assets exceed their forward sales interest on the difference between these two aggregates. The amount of interest due shall be calculated in proportion to the average daily balances.

19.2 The rate of interest provided for in Article 19.1 of the present

Agreement shall be determined in accordance with the provisions of Article 8 of the present Agreement. Such interest shall be paid monthly.

Article 20 - Liquidation

20.1 Save in the event of a unanimous decision to the contrary, the swaps of gold and dollars against ECUs referred to in Article 17.3 of the present Agreement, shall be unwound at the end of the two-year transitional period.

20.2 For this purpose central banks that are net users of ECU assets shall bring these back up to a level equal to that of their forward sales and central banks that are net accumulators shall transfer to the net users the excess of their ECU assets over their forward sales either directly or through the intermediary of the EMCF.

20.3 The transfers of ECUs provided for in the preceding paragraphs shall be effected in exchange for the currency of the central banks that are net accumulators, or in accordance with any other arrangements agreed between the parties, or against the transfer of reserve components in proportion to the composition of the reserves of the central bank repurchasing ECUs, this composition being determined in accordance with the provisions of Article 16.2 of the present Agreement.

Article 21 - Institutional provisions

The Committee of Governors shall periodically review the operation of the present Agreement in the light of experience gained.

Article 22 - Termination of the Agreement of 10 April 1972

22.1 The present Agreement terminates and replaces, with effect from 13 March 1979, the Agreement of 10 April 1972, as amended by the Agreement of 8 July 1975, establishing a system for the narrowing of the margins of fluctuation between the currencies of the European Economic Community.

22.2 The present Agreement shall be drawn up in duly signed versions in English, French and German. A certified copy of the original in each language shall be sent to each central bank by the Secretariat of the Committee of Governors, which is required to retain the originals.

Done at Basle, 13 March 1979

Banque Nationale de Belgique
C. de Strycker

Central Bank of Ireland
C.H. Murray

Darmstadt Nationalbank
Erik Hoffmeyer

Banca d'Italia
Paolo Baffi

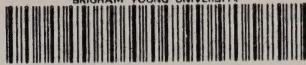
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